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Alternative
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**PRIVATE EQUITY
INTERNATIONAL**

PRIVATE EQUITY ACCOUNTING

The global guide for private equity firms and fund accountants

Mariya Stefanova
PE Accounting Insights



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THE QUEEN'S AWARDS
FOR ENTERPRISE

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To my wonderful children, Alex and Lilly, who inspired me to write this book, my partner Dimitar who has supported me at all times, and my mom who has always been there to provide a helpful hand.

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Thank you all.

Mariya Stefanova

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Mariya Stefanova is a founder partner of PE Accounting Insights, a private equity accounting training and consultancy firm, providing specialist training and technical advice for private equity houses, fund administrators and individual fund accountants. She has more than seven years of experience in private equity accounting and more than three years of experience in training fund accountants during which period she has trained over 130 fund accountants.

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Introduction to private equity

for accountants

By Mariya Stefanova

This chapter discusses:

- A brief history of private equity
- How to define private equity?
- The mechanics of the private equity fund: open-ended versus closed-end funds
- Limited-life versus evergreen funds
- Limited partnerships
- Regulation in private equity
- Private equity as part the alternative investment asset classes
- Liquidity
- Value creation
- J-Curve

History of private equity

From a number of historical sources and varied interpretations of economic history developments, different authors can draw different plots about the history of private equity. To describe the history of this asset class in any significant detail is outside the scope of this publication, so I have included a brief outline of some of the ways in which the private equity industry has developed over the ages without claiming any originality or historical authenticity of my sources. As a private equity accounting practitioner, you may even want to skip this part and dive into the specific areas of interest.

However, it is vital for any accountant dealing with private equity to

understand the commercial nature, the mechanics and the transactions of the fund that will be translated into accounting processes and entries later in this book. Therefore, I would recommend that a private equity industry novice read this section in order to gain a deeper understanding of the evolution of private equity.

Whereas some people think that private equity started in the US after the Great Depression in the 1930s, others think that it is as old as human civilisation itself. Pierre-Yves Mathonet and Thomas Meyer, in the introduction to their book, *J-Curve Exposure: Managing a Portfolio of Venture Capital and Private Equity Funds*, view Queen Isabella of Castile as a private equity sponsor and the purchase of an interest in Christopher Columbus' voyage of discovery as a private equity investment whereby she provided not only financial back-up, but also management and recruitment assistance.

This can clearly be said to mimic, to a certain extent, the activities of a contemporary private equity sponsor or manager. Mathonet and Meyer continue with their interesting analogy by describing the refusal of King John II of Portugal to provide financial support to Columbus as an exercise in due diligence, as it followed his request for an independent opinion from his experts on Columbus' proposal.

Ancient forms

Ancient Rome and Italy

Exploring the history of the limited partnership – the most common legal form for private equity or venture capital funds – it seems that the '*societates publicanorum*', which started to be used in Rome in the third century BC, may have arguably been the earliest form of limited partnership. Later on in mediaeval Italy, another form resembling the private equity structure called 'commenda' appeared, where tenth century Italian merchant families financed trade voyages using an early form of limited partnership. This partnership had 'sleeping partners', who were not liable for any debt and stayed at home (similar to limited partners (LP) in a modern limited partnership), while the 'travelling partners' controlled the venture and set sail to search for profitable businesses (similar to the general partner (GP) in a modern limited partnership).¹

Mediaeval Islamic world

Forms of limited partnership not only appeared in Europe; in the mediaeval Islamic world the Qirad and Mudarabah institutions were legitimised by Islamic law and jurisprudence. Both institutions are used

to signify the same idea, and resemble the Italian commenda quite closely: “To give somebody out of your capital a part to trade in, provided that the profit is shared between both of you, or that an apportioned share of profit is allocated to him... accordingly, the active partner is called Darib, because he is the one who travels and trades. It is also possible that both capitalist and active partner are called Mudarib or Muqarib as both share the profits with each other. The Makkans were depending on commerce for their livelihood; and those who could not exercise commerce by themselves, travelling long distances and leaving their homes for long periods, used to give capital to those able and willing to trade against a certain percentage of net profit.”²

More recent history

In more recent history, the roots of private equity can be traced, as a more organised form of investment, back to private financing employed by the railroad and textile mills in the 19th century. However, three largely negative events in the first half of the 20th century provided the most significant boost to the industry – the two World Wars and the Great Depression of the 1930s.³

The First World War and the War Finance Corporation

The First World War set the scene for private equity when, on April 5, 1918, the US Congress created the War Finance Corporation (WFC) to provide financial support to industries essential for the war and to banking institutions that aided such industries. Since government borrowing to pay for the war had attracted a significant amount of private capital, little capital was available for corporations to borrow. The WFC was designed to make such capital available, but it also assisted in the transition to peacetime by financing railroads under government control, and making loans to US exporters and agricultural cooperative marketing associations before it was abolished on July 1, 1939.

The Great Depression and the Reconstruction Finance Corporation

The next event to set the scene further was the Great Depression, which started in 1929 in the US and quickly spread around the world, lasting until the early 1940s in some regions. In response, US president Herbert Hoover created the Reconstruction Finance Corporation (RFC) to alleviate the financial crisis by lending money to all businesses damaged by the Depression.

The Second World War and the Smaller War Plants Corporation

The Second World War brought the creation of the US Smaller War Plants Corporation (SWPC) in 1942, particularly targeting small businesses which were unable to compete with the more resistant large corporations. Lending money to such small private enterprises and encouraging large financial institutions to make credit available to them became the focus of the SWPC.⁴

American Research and Development Corporation and the father of Venture Capital

A few other events leading to government initiatives contributed to the development of private equity, but the most prominent one was arguably the creation of American Research and Development Corporation (ARD), which is widely considered to be the first organised venture capital firm when it was founded in 1946 by general Georges Doriot who, by many accounts, is described as the father of venture capitalism. A former French army general, Doriot immigrated to the US in the 1920s to earn an MBA and subsequently became a professor and then dean of the Harvard Business School. ARD was originally founded to encourage private sector investments in businesses run by soldiers who were returning from the Second World War. ARD's major success was its investment in 1957 of \$70,000 of equity into a company called Digital Equipment Corporation (DEC), founded by two engineers from the Massachusetts Institute of Technology (MIT), Ken Olsen and Harlan Anderson, who were working on a minicomputer. In the 1970s, when ARD floated the company, the initial public offering (IPO) raised over \$38 million.⁵

Other industry boosters

There were also a number of other high-profile organisations and wealthy individuals and families investing in private companies during the first half of the 20th century, such as J.H. Whitney & Company, the Vanderbilts, the Rockefellers and the Warburgs. Increasingly, further legislative change and advancements in financing trends boosted the industry largely in the US:

- **The Investment Company Act and the Small Business Investment Company (SBIC) Program** – In 1958, the Investment Company Act in the US created the SBIC Program, which supplied equity capital, long-term loans and management assistance to qualifying small businesses, and also played a significant part in the genesis of the modern private equity industry.⁶
- **The growing IPO market in the 1960s** – In the 1960s, the bull IPO market further assisted the growing popularity of venture capital.

- **ERISA legislation** – Following the plummeting stock market in the 1970s, a new piece of legislation was introduced in the US in 1974, namely the Employee Retirement Income Security Act (ERISA), which established minimum standards for pension plans in private industry, ERISA unintentionally caused pension funds to stop investing in high-risk investments, including private equity and venture capital. When the Prudent Man Rule in the same legislation was clarified later in 1978 to allow pension funds to invest in private equity and venture capital, the initial unintended negative effect was not only rectified but further boosted the industry with some big institutional investors gradually starting to increase their allocations to private equity and venture capital.⁷
- **Other tax developments in the 1980s** – The Steiger Amendment introduced changes to the tax legislation in the US, with the top rate of capital gains tax (CGT) being reduced from 49 percent to 28 percent, and even further reductions following the Tax Act of 1981 additionally boosted the industry.

Private equity in the 21st century

With extensive growth and proliferation into Europe and particularly the UK from the 1980s, venture capital and private equity blossomed from what was at the start of the 20th century a cottage industry into a well-organised alternative asset class, demonstrated by the boom years between 2003 and 2007. As with any maturing asset class the global private equity industry has developed many derivative investment strategies that cater for a number of specialist investment stages and strategies, such as mid-market buyout funds, large leveraged buyout funds, multi-billion dollar private equity funds, infrastructure funds of all sizes, private equity real estate funds, mezzanine funds, distressed and special-situations vehicles, secondaries funds and funds of funds. As the whole universe of private equity recovers from the deeply penetrating global financial crisis, which unfolded in 2008 with the collapse and near-collapse of many financial institutions, the new paradigm for private equity is still evolving. Closer regulatory scrutiny in the US and Europe, a shift in the balance of power between general partners and limited partners, greater questioning of private equity's returns by informed commentators and academics and the shift in economic power from the West to the East are just some of the major developments shaping the future of the whole private equity class.

What is clear in 2011 is that the private equity industry has undisputedly come a long way since the birth of post-war entrepreneurial optimism of the 1940s.

How to define private equity

Having taught private equity fundamentals to accountants for years, the easiest way to explain private equity to newcomers to the industry is by simply defining the meaning of the two words: 'private' and 'equity'. In simple terms, 'private' indicates that the investments are made into private or non-listed companies; 'equity' describes investing in equity stakes in those private companies. Although this might be true in the majority of cases, this definition is over-simplistic and, if applied universally, may overlook transactions that are still considered to be part of the asset class, including, for example, public-to-private transactions or private equity investments in public equity (PIPE) deals, or when the deal is structured as convertible debt. A good example of a high-profile PIPE deal is the Alliance Boots transaction in 2007 when a consortium comprising KKR and Alliance Boots' own deputy chairman, Stefano Pessina, won the bidding war against a rival consortium led by another big private equity house, Terra Firma, to become the first FTSE 100 company to be taken private by a private equity fund.⁸

Bearing this in mind, when explaining private equity to future accountants I always add the proviso that, in the modern world of private equity, it is not always private, nor equity only. Sometimes in investment schedules there is a mixture of listed and non-listed companies and almost always a mixture of debt and equity or even hybrid instruments, for example, preference shares or convertibles.

To elaborate on the definition, private equity can be described as a collective investment scheme whereby investors' money is pooled together using commitments that are drawn down over the life of the fund and invested in private companies through a mixture of equity and debt instruments.

How does a private equity fund work?

As described in the aforementioned definition, investors commit to the fund on day one; commitment is a legal obligation, assumed by the investors, to deliver funds over the life of the fund (not on day one) as and when funds are needed for investments, management fees or other fund expenses.

A private equity fund manager uses its talent and know-how to find new investments: once an investment is found, the relevant amount is drawn down from investors out of their total commitment and invested in the portfolio company. The private equity manager then works

closely with the management of that portfolio company over the holding period (an average of three to five years), aiming to improve the company and raise its value, so that it can potentially be sold to another investor or be floated on the stock market at a profit. Part of this profit would then be returned to the investors and a percentage kept by the manager in the form of an agreed performance fee, which is known as carried interest or carry.

The money invested in the portfolio company could be used for a variety of purposes, including:

- starting up a business (start-ups in the case of venture capital);
- developing new product lines;
- funding new technologies;
- making new acquisitions or strengthening its organic growth;
- expanding working capital or simply strengthening its balance sheet;
- restructuring the company; or
- resolving ownership problems, for example, management buyouts or management buy-ins.

Open-ended versus closed-end funds

Open-ended funds are collective investment schemes whose capital does vary over time, and for that reason they are also called variable-capital funds; the capital in those funds expands as shares or units are issued, and contracts when shares or units are redeemed. Examples of open-ended funds are unit trusts, open-ended investment companies (OEIC) and investment companies with variable capital (ICVC) in the UK, mutual funds in the US, société d'investissement à capital variable (SICAV) in Luxembourg, hedge funds and exchange-traded funds (ETF).

At the other end of the spectrum are the closed-end funds; their capital does not vary over time and their size, respectively, is constant, which is why they are also referred to as 'invariable-capital funds'. New shares (units or other instruments) are rarely issued once the fund has launched and shares are normally not redeemable until the fund is liquidated. Examples of closed-end funds are investment trusts in the UK and closed-end companies in the US.

Private equity funds usually take the form of a closed-end fund with their fixed capital being the total commitment which does not change over the life of the fund.

Limited-life versus evergreen funds

In addition to the closed-end structure that the private equity funds adopt, with single or multiple closings (a 'close' or 'closing' is any intake of new investors in the fund), private equity funds are also usually limited-life funds with a typical life of ten years. There is the further possibility for limited-life funds to be extended by two years if the general partner deems such an extension to be appropriate. In contrast, there are evergreen funds, with no time restrictions limiting the life of the fund. For all fund structures, the first half of the fund life (approximately, but not necessarily, the first five years of the term) is called the 'investment period' and the second half is called the 'divestment period', although there is typically an overlap between investment and divestment period.

An additional distinction to be made is that while evergreen funds keep recycling the proceeds from disposal of investments, a private equity fund will have returned all the contributions back to its investors by the end of its life, resisting a redraw or clawback of any distributions previously returned to the investors. There are limited exceptions to this rule, usually being the amounts drawn to pay fund expenses by rationalising that such amounts "have not yet been productively invested or put to work" by the fund, or the amounts used to fund temporary and bridge investments (usually less than 12 months) sold as a "quick flip".⁹

Limited partnership (and fund for joint account)

Limited partnership (or funds for joint account used in certain jurisdiction) is the preferred legal form when structuring private equity funds because the limited partnership is a tax-transparent entity¹⁰ – "an entity which is not taxed either in representative capacity or in its own capacity as a tax-paying entity, but the tax is levied on the participants in the entity based on their share of income in the entity".¹¹ It is called a tax-transparent or see-through entity because it is treated, for tax purposes, almost as if it does not exist, as if you can see through it all the way to its individual limited partners. In the context of a fund structured as a limited partnership that would mean that the partnership (the fund) itself will not be taxed at the legal-entity level (at the fund level), but the limited partners will bear the tax burden instead or from the limited partner's perspective, they will be taxed as if that limited partner has a direct investment in the underlying portfolio. The partnership though may still have some obligations to the relevant tax authorities, for example, in the UK and the US, the partnership still needs to file partnership tax returns, but generally the fund will not be

subject to taxation.

Regulation and private equity

Private equity funds are usually restricted to sophisticated investors with the very best of them – the so-called top-decile funds – being even invitation-only. This is the reason why, in most jurisdictions, private equity vehicles are usually subject to less regulation (compared to other investment vehicles such as wholesale funds) typically falling within the spectrum from non-regulated to low-regulated vehicles. As only professional investors are allowed to invest in private equity funds, the low level of regulation is justified by the fact that sophisticated investors are professional investors who know what they are doing and should be responsible for their risk-taking. Therefore, professional investors do not need the government or regulator to protect them to the same extent as the general public (unsophisticated investors) would. For that reason, private equity funds are usually non-regulated/unregulated; however, it is important to make a distinction between the fund and the other entities within the structure, or in some cases outside of the structure, as in some jurisdictions, such as the UK, although the fund itself is considered an unregulated collective investment scheme (CIS), the person who sets up or operates the scheme from the UK must be authorised by the Financial Services Authority (FSA) and that person is called an ‘operator’ of the scheme.¹² Usually the regulated entity (the operator) is the manager or the GP.

The US Securities and Exchange Commission (SEC) used to take a slightly different regulatory approach. The Investment Advisers Act of 1940 (Advisers Act) required registration of fund advisers that provided investment advisory services to more than 15 clients, but private equity firms used a registration exemption available to advisers with less than 15 clients that avoided “holding themselves out to the public” in the US as investment advisers (Private Advisers Exemption) thus avoiding Advisers Act registration.

The registration under this regime was less onerous than its UK counterpart, but with the new regime, effective from July 21, 2011 (although the deadline for registration was postponed until March 30, 2012), the rules have tightened. Following the global financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was introduced as an attempt to reform the US financial system.¹³ The new Private Fund Investment Advisers Registration Act of 2010 (Registration Act), as part of the Dodd-Frank

Act, removed the Private Adviser Exemption previously set forth in Section 203(b) (3) of the Advisers Act, 14 and introduced three new exemptions instead (the Private Fund Adviser Exemption, the Foreign Private Adviser Exemption and the Venture Capital Fund Adviser Exemption), which in practice mean that unless they qualify for some of the exemptions, all private fund advisers, including non-US advisers, with \$150 million or more of assets under management (AUM) attributable to US investors, are required to register with the SEC as investment advisers under the Advisers Act by March 30, 2012.

However, the financial crisis did not precipitate change only in the US, as Europe has constructed an even more draconian piece of legislation in the shape of the Alternative Investment Fund Managers Directive (AIFMD). After long debates and lobbying, on November 11, 2010, the European Parliament plenary approved the final text of the AIFMD and the European Union (EU) member states will have two years from the date of publication in the official journal in early July 2011 to transpose the directive into their local legislation. In practical terms this means that from July 2013, this directive will impact all the alternative investment fund managers that not only have registered offices in the EU, manage alternative investment funds authorised or registered in the EU, or have registered offices or a head office in the EU, but also those funds that market any alternative investment funds in the EU.

Therefore, even if the fund or its fund manager has no connections with the EU, but markets the fund to investors in the EU, it would have to comply with the directive.

The AIFMD will impose a number of strict requirements with regards to authorisation, including marketing (passport regime), capital requirements, risk management, internal and external reporting, valuation, depositary requirement, remuneration policies and operating models, which may impose a huge administrative burden and significantly increased costs. This may potentially bring an end to some smaller funds that will be unable to bear the costs of implementing the requirements of the AIFMD.

Private equity as part of alternative investment asset classes

Private equity is considered to be part of the so-called alternative investment asset classes, that is, alternative to traditional portfolios, which typically comprise stocks or listed equities, bonds and cash

deposits. Historically, alternative asset classes have included real estate, commodities, rare coins and stamps, gemstones, artwork and even trading cards, but these days they are usually associated with hedge funds, private equity, venture capital, real estate funds, infrastructure funds and commodity funds.

Alternative investment asset classes are appealing to investors because their lack of correlation with other types of investments may help to increase or stabilise portfolio returns. Part of the approach to robust portfolio management is diversifying investments, so that if one type of investment is performing poorly, another can make up the shortfall.¹⁵

Another attraction might be, as mentioned above, the more relaxed inherent regulatory requirements. However, what alternatives bring to the table, as part of bigger portfolios, is the different risk-reward profile usually taking the form of consistently higher returns than the traditional instruments, as a trade-off for the perceived increase in risk. It is debatable, however, whether ‘gambling’ on the stock of one company is less risky than investing in a fund of funds where your risk is spread over a wide basis of underlying portfolio companies. Good examples would be investing in BP’s shares, which following the oil spill off the Gulf of Mexico in 2010 became associated with the worst environmental disaster in US history, or the departure of a key person, such as Apple’s CEO Steve Jobs taking an undisclosed leave of absence due to health concerns. These events caused the share price of both companies to plummet and could have potentially proved fatal for an investor with an ill-diversified portfolio.

Liquidity

Private equity funds, considering their closed-end and limited-life nature and the typical ‘10-and-2’ lock-up period, are generally considered to be illiquid and perceived to be long-term investments. However, despite the low liquidity widely assumed by investors, it is important to bear in mind that there is still the mechanism of partner transfers provided for in the limited partnership agreement (LPA), as well as secondary fund investing. Partner transfers will be discussed **Chapter 8**. As for secondary transactions, while the illiquid nature of private equity funds is “strictly true as a matter of law”, in practice, there is a very active secondary market, with specialist secondary funds that would readily quote a price for your interest in a private equity fund.¹⁶

Value creation

Some people describe private equity firms as 'locusts', a pejorative term which found fame after the then chairman of Germany's Social Democrat (SPD) party Franz Müntefering coined the phrase in a speech in April 2005 to describe private investors, private equity funds and investment banks. Private equity has been criticised across Europe, particularly in countries with a tradition of strong socialist politics, such as Denmark, France and Germany, and their lexicon of opposition has adopted words such as 'locust' and phrases including 'asset strippers' when referring to the private equity managers.

In 2007, as a result of a debate sparked by the trade unions, the UK Treasury Select Committee summoned a group of bosses from some of the largest UK-based private equity firms to question them about private equity practices. One commonly cited phrase to make it the journal of classic private equity quotes is that private equity partners "pay less tax than a cleaning lady", according to a comment made by Nicholas Ferguson, chairman of SVG Capital.¹⁷

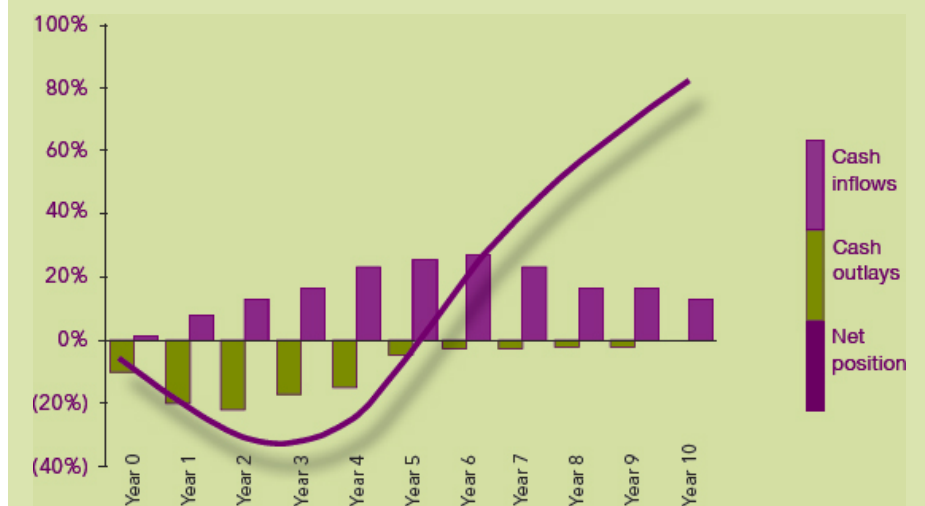
Notwithstanding the great scrutiny, public relations stumbles and intensifying regulation, private equity as an investment model has the potential to outperform other asset classes. When it comes to creating value, a fully operational and professionally motivated private equity fund works intimately with a portfolio company's management over the investment holding period to improve the company's value, so that maximum return can be achieved at exit.

The J-Curve

This introductory chapter would not be complete without mentioning the J-Curve – also referred to as the hockey stick – as returns are negative in the first years followed by a positive upswing in return in successive years. In my career I have worked with and trained many private equity fund accountants, many in senior positions who have never heard of the J-Curve, so it is important to mention this very private equity phenomenon here.

The J-Curve is the perfect depiction of the fund lifecycle in terms of its returns, represented by the cash flows between the investors and the fund, and calculated as an internal rate of return (IRR) on these cash flows (see [Figure 1.1](#)). This is used to illustrate the historical tendency of private equity funds to deliver negative returns in early years (during most of the investment period) – the so called 'valley of tears' – before beginning to show positive returns later on in the lifecycle as the

Figure 1.1: The J-Curve: fund lifecycle in terms of its returns



Due to the specifics of the private equity fund lifecycle and the mechanics of a private equity fund, depicted best by the J-Curve, unlike other traditional asset classes, where periodic, usually annualised returns are used to measure performance, in private equity annual returns are not a valid measure and cannot be used as a guide to private equity performance.¹⁹ Instead, cumulative returns on a since-inception basis, represented by the IRRs and coupled with some multiples are considered to better reflect the private equity fund and manager's performance. How performance is measured in private equity is explained in more detail in [Chapter 18](#).

Conclusion

In this chapter I have outlined the brief history of private equity and discussed the fundamentals of the asset class, starting with the definition, through to the mechanics and the differentiators of a private equity fund – comprising its open-endedness, limited life, limited liquidity, light regulation, its place among alternative investment asset classes with its potential to outperform other asset classes, the most popular legal form for PE funds. I've also addressed the limited partnership (and fund for joint account); the J-Curve as the best depiction of a private equity fund's returns over its lifecycle; and the public perception and the value creation of the asset class.

- ¹ The Origins of Western Economic Success, Meir Kohn.
- ² Money, interest and quirad, Mahmud Abu Saud.
- ³ Private Equity – History, Governance, and Operations, Harry Cendrowski, James P. Martin, Louis W. Petro and Adam A. Wadecki.
- ⁴ Ibid.
- ⁵ Cendrowski *et al.*
- ⁶ For further information, see www.sba.gov
- ⁷ Cendrowski *et al.*
- ⁸ KKR Wins Race for Alliance Boots, by James Quinn and Richard Fletcher, *The Telegraph*, April 24, 2007
- ⁹ The Debevoise & Plimpton European Private Equity Handbook 2004, Debevoise & Plimpton.
- ¹⁰ Other common terms for this include see-through, look-through, pass-through and flow-through but, whatever the term the meaning is essentially the same.
- ¹¹ Securitisation glossary, Vinod Kothari.
- ¹² According to the *FSA Handbook* glossary: “Operator (in relation to any other collective investment *scheme* (which includes unregulated schemes within which category falls PE and VC funds)) any *person* who, under the constitution or founding arrangements of the *scheme*, is responsible for the management of the property held for or within the scheme.”
- ¹³ Financial Reform Matters: Non-US Private Fund Managers Required to Register with the SEC, Jason E. Brown, Raj Marphatia, William F. McCormack and Mark J. Tannenbaum, Ropes & Gray LLP
- ¹⁴ Summary of Regulatory Obligations of Registered Non-US Investment Advisers to Private Equity Funds, Ropes & Gray LLP.
- ¹⁵ Alternative Assets Classes: An Introduction, Gregory H. Skidmore, Belray Asset Management.
- ¹⁶ Private Equity as an Asset Class, Guy Fraser-Sampson, *John Wiley & Sons*, 2010.
- ¹⁷ Extra tax break for buy-out partners, Martin Arnold, *FT.com*, June 19, 2007.
- ¹⁸ Exposed to the J-Curve: Understanding and Managing Private Equity Fund Investments, Ulrich Grabenwalter, Tom Weidig; J-Curve Exposure: Managing a Portfolio of Venture Capital and Private Equity Funds, Pierre-Yves Mathonet, Thomas Meyer
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Private equity structures and

types of funds

By Mariya Stefanova

This chapter discusses:

- Private equity fund structures
- Legal form and choice of jurisdiction
- Examples of fund structures – UK versus US structures
- Some important similarities and differences in the limited partnership agreement (LPA) terms of UK and US funds
- Some basic accounting implications
- Types of private equity funds
- Some basic accounting similarities and differences between different types of funds

Private equity fund structures

There are two crucial documents a fund accountant needs to understand in order to be able to prepare reliable financial statements (accounts) for a private equity fund:

- 1.The legal structure of the fund.
- 2.The terms of the limited partnership agreement (LPA).

In this chapter, I will focus on summarising some specific details of the most popular fund structures that are important in terms of accounting. An accountant does not need to be a lawyer or a tax expert, but there are certain basic concepts that he or she must understand. While this book is not meant to be a comprehensive guide to fund structures, if you are interested in finding out more about this subject you can read

a comprehensive reference to all fund structures in *Private equity fund structures* by the Private Funds Group at Clifford Chance in [Appendix I](#) of this book.

The first point to understand is that the fund structures are predominantly tax-driven, aiming to minimise the tax amount for the partners, the fund and related entities, or in other words for the structure as a whole, as well as for its individual participants.

Limited partnerships and tax transparency

In [Chapter 1](#), I explained that a limited partnership (and its equivalents) is the preferred legal form for private equity funds as this is a tax-transparent entity. The partnership is regarded as tax-transparent, mainly for the purposes of capital gains, whereby the assets of the fund, which are usually investments in portfolio companies, are considered to be held by the partners as direct investments, not by the partnership itself. Such transparency, however, does not mean the fund is forgotten by the tax authorities; the partnership may still need to file partnership returns in certain jurisdictions as mentioned in [Chapter 1](#) or withhold tax on interest from debt instruments from certain non-exempt limited partners, for example.

Legal form and choice of jurisdiction

Although the structuring considerations are explained in detail by expert lawyers in [Appendix I](#), it is important to mention a few important considerations that are discussed at seminars and in a few very good publications that I treasure (see footnotes), which have proved to be very useful in my practice as a fund accountant and trainer.

One of the first challenges for a lawyer and tax adviser is to decide on the jurisdiction of the fund and related entities. The fund could be structured as a Delaware limited partnership; a limited partnership in another onshore common law jurisdiction, such as England or Scotland; or an offshore common law jurisdiction, for example, the Cayman Islands or Channel Islands; or a corporate fund vehicle, such as a Netherlands *besloten vennootschap* (BV); a Luxembourg *société d'investissement à capital risque* (SICAR) or a specialised investment fund (SIF), which seem to be increasingly popular in Europe since they first appeared in 2004 and 2007, respectively; or a local vehicle, such as a *fonds communs de placement à risque* (FCPR), a French venture capital fund, or an *Italian fondo chiuso* (FC).¹

A combination of factors, such as the jurisdiction or domicile and the specific tax circumstances of the investors, along with the nature and geography of the investments, will be taken into consideration and their advantages or disadvantages reviewed before a final decision can be made.

Onshore versus offshore funds

Reviewing the advantages or disadvantages of setting up a fund in an offshore or onshore jurisdiction is outside the scope of this book, but it is worth mentioning them in brief in order to help fund accountants gain a better insight into the fund structures they work with.

It is important to remember that offshore structures are usually not required to prevent tax arising at the fund level (particularly direct tax), as that is naturally resolved by the transparency of the limited partnership structure.

Across Europe, including the UK, the main reason for setting up a private equity fund offshore is to reduce the cost of value-added tax (VAT), with most of the supplies being VAT-exempt, which would result in only partial recovery of VAT on the services received by the manager.²

Another possible reason, applicable to both European and US funds, might be to simplify the admission of investors and accommodate the particular requirements borne by their specific tax and regulatory circumstances or the nature of the investments and/or their jurisdiction.

It is worthwhile considering that there are also disadvantages to the offshore structures and the offshore route should only be taken if the advantages outweigh these. One such disadvantage is that the fund must be unambiguously demonstrated as being run from overseas with nothing suggesting onshore management and/or control, as that could jeopardise the tax status of the fund. A fund accountant should be aware of the significance of all of these requirements, as even seemingly minor items, such as the invoices for the fund being received and paid by the onshore manager, could contribute to a tax official deciding not to honour the fund's offshore tax status.

Extra caution should be applied now that, as a result of the global financial crisis, the tax authorities on both sides of the Atlantic are scrutinising all offshore activities.

A good example of recent years is the UK tax case *Laerstate BV v.*

HMRS in September 2009, where central management and control were questioned and all actions by director Dieter Bock, who was chief executive of Lonrho Plc in the early 1990s, were scrutinised and, as a result, the case found that central management and control was exercised onshore.³ Another disadvantage of setting up an offshore fund is the costs incurred to maintain that offshore status.

European versus US funds

The limited partnership, as it stands today in mid-2011, despite its continental European origins as discussed in [Chapter 1](#), has ultimately been established as an Anglo-Saxon legal form. In some jurisdictions, adjustments to existing legal forms are made and new hybrids are developed for familiarity of investors from other jurisdictions, so that they can feel more comfortable by using a legal forms they are more familiar with, which are typical of their own jurisdiction.

A good example is the Luxembourg legal form, the société en commandite par actions (SCA), a partnership limited by shares, which tries to combine features of the Anglo-Saxon partnership with the features of a corporate entity more familiar in continental Europe, but there are also other examples of such hybrids developed and used in Europe.

Despite the variety of legal forms presently available on the market, the traditional limited partnership, which features tax transparency, is still the preferred legal form for private equity funds, with the two most popular choices being the English limited partnership⁴ in Europe and the Delaware limited partnership in the US. Today, due to the ongoing integration of markets, the key terms of the European and US funds do not differ significantly, but there are still various key differences, some that are commercial and others that are driven by tax implications.

Both of these aspects are important to fund accountants, so that they can gain an improved understanding of these structures and organise their accounting and reporting in a more efficient way to better cater for investors' and sponsors' reporting requirements.

Similarities and differences between English and US limited partnerships

Considering the convergence of terms between Europe and the US and the constantly changing landscape of the industry, I have summarised the most prominent similarities and differences between a

typical UK and a typical US fund below. There is reference to the management fee, carried interest, waterfall and commitments.

Similarities

The following key terms, which are important to a fund accountant, are common to both English and US limited partnerships:

Management fee

- Typical annual management fee – within the range of 1.5 percent to 2.5 percent, but usually 2 percent, and calculated on the total capital committed (although other basis of calculation are also possible as explained in [Chapter 12](#)) for the period before the end of the investment period and on the actively invested capital for the period after the investment period end.
- Transaction and other advisory fees earned by the manager (or its associates) – offset against the management fee, typically by 50 percent, although sometimes up to 80 percent (to mimic the 80/20 carry). Institutional Limited Partners Association (ILPA) tried to endorse the 100 percent offset in its Private Equity Principles Version 1.0, published in September 2009, but it was removed in the latest Version 2.0 published in January 2011 (see www.ilpa.org).

Carried interest/waterfall

When a whole-of-fund carried interest model is adopted by the fund, managers are rewarded on the return of a fund as a whole, with the following terms applying:

- 80/20 carried interest (carry), with the exception of funds of funds.
- 8 percent preferred return (hurdle).
- 100 percent catch-up after the preferred return/hurdle, to allow the carried interest partner to catch up with the LPs before the 80/20 carried interest.

Differences

The following key terms, which are important to a fund accountant, denotes differences in English and US limited partnerships:

Commitments

In European funds organised as English limited partnerships, the commitment is split in capital contributions and loan contributions, to address a problem in the English Limited Partnership Act 1907, explained later in this chapter, whereas in US funds the whole

commitment is in the form of capital contributions.

Carried interest/waterfall

- Recipient of carried interest – the founder partner (FP) in the UK, and the general partner (GP) in the US.
- Carried interest models – the whole-of-fund model is historically typical for European funds, whereas deal-by-deal carry models are more typical in the US. However, at present, the whole-of-fund model seems to have become a universal norm, also endorsed by the ILPA Private Equity Principles.
- Carried interest clawbacks and clawback security – holdbacks and escrows are typical in Europe whereas personal guarantees are more typical in the US.

Management fee

- Management fee in the US versus priority profit share (PPS) in the UK.

Typical vanilla UK versus US fund structures

Figure 2.1 presents a vanilla UK private equity fund structure with the fund set up as an English limited partnership, in which the main participants in the fund structure are illustrated.

Figure 2.1: Simple UK private equity fund structure

may have participated in the control of the partnership, as explained in an article in the *Paul Weiss Summer 2010 Investment Management News* entitled Delaware LLLPs: A Viable Option for Private Investment Funds? LPs make capital (equity) contributions of usually 0.001 percent of the total commitment that is drawn when an LP is admitted to the partnership. This is not returned until the partnership is wound up and the remaining 99.999 percent is in the form of loan (debt) contributions drawn by the GP as it is needed for investments, management fees/PPS or fund expenses, and it is subsequently returned to the LPs as investments are disposed of.

The reason for splitting the contributions in two is that in English limited partnership law, no part of the LPs' capital contributions can be irrevocably returned to the LPs before the dissolution of the partnership. If capital contributions are returned to the LPs earlier, they will lose their limited liability status proportionately to the capital returned and they may be required to be re-contributed to satisfy the partnership's liabilities.⁶ The accounting of the fund is done at the level of that entity.

General partners

Partnership law requires that there is someone (and that someone is the GP) to take an unlimited liability to third parties (creditors) within the partnership structure. In theory, as required by partnership law, the GP manages the fund, including making investment decisions. However, in practice, the GP is a paper entity only, with no staff or assets, and the fund manager is the one to provide the know-how to run the fund. All the investment professionals typically sit at the manager level, so it can be said that the GP manages the fund on the advice of the manager. To avoid the unlimited liability, usually called by lawyers 'liability protection' or 'liability shield', the GP is usually set up as limited liability entity, for example a limited company (or limited liability company in the US). However, the fund GP will still be subject to liabilities relating to its fiduciary duties as a fund adviser.

In some structures, the GP can make a commitment to the fund, typically 1 percent of the total commitment (but it can vary according to the LPA), in its capacity as an investor, so we can see the GP in two different capacities – GP as a GP and GP as an LP. That distinction is very important for a fund accountant in terms of accounting processes and allocations.

Accounting of the GP is kept separately, and the format and filing requirements of the accounts will depend on the legal form. This is explained in more detail in [Chapter 21](#), but it tends to be very simple

and with a low level of transactions with pretty much only the management fee/PPS (in and out), carried interest (if there is no separate entity set up as carried interest partner) and some expenses.

Founder partner

The founder partner (FP) may or may not be present in a UK limited partnership structure. It is basically the carried interest partner, set up as a separate entity, for tax efficiency, in order to comply with the structure agreed between the British Private Equity and Venture Capital Association (BVCA) and Her Majesty's Revenue and Customs (HMRC), which was previously known as the Inland Revenue, in a statement in 1987 and subsequently in two memorandums of understanding in 2003, which is a condition in order for the private equity or venture capital funds to benefit from the more beneficial tax treatment of carried interest.

The way it works is that the FP contributes 20 percent of its capital (equity) to the partnership, calculated on the capital commitments (the 0.001 percent of the total contribution as explained above, not the total commitment). This percentage is in line with the 20 percent carry and the FP should maintain that percentage at each closing or at the final closing (as required by the LPA). The FP's participation is viewed as an investment in the fund, which is like a highly leveraged investment in the sense that the FP puts a very small proportion of capital in the fund and by way of its interest carried by the LPs – that is why it is called 'carried interest' – achieves a result similar to one in a highly leveraged investment – small capital big returns, and, based on its investment the FP receives the carry as a return on its investment rather than as a performance fee, so it is taxed as a capital gain with a capital gains tax (CGT) instead of income tax (the rate of CGT in the UK is still lower than income tax) and no invoice is raised, nor VAT charged.

The FP is often organised as a limited liability partnership (LLP) with the individuals who are partners in receipt of carried interest being partners of the LLP.

Similar to the GP, the FP may contribute to the fund as an LP, so in some structures you may see the FP in two different capacities – FP as an FP (partner in receipt of carried interest) and FP as an LP. Once again, there is an important distinction to be made here in terms of accounting processes and allocations.

Manager

Accounting and filing requirements for the FP, similar to the GP,

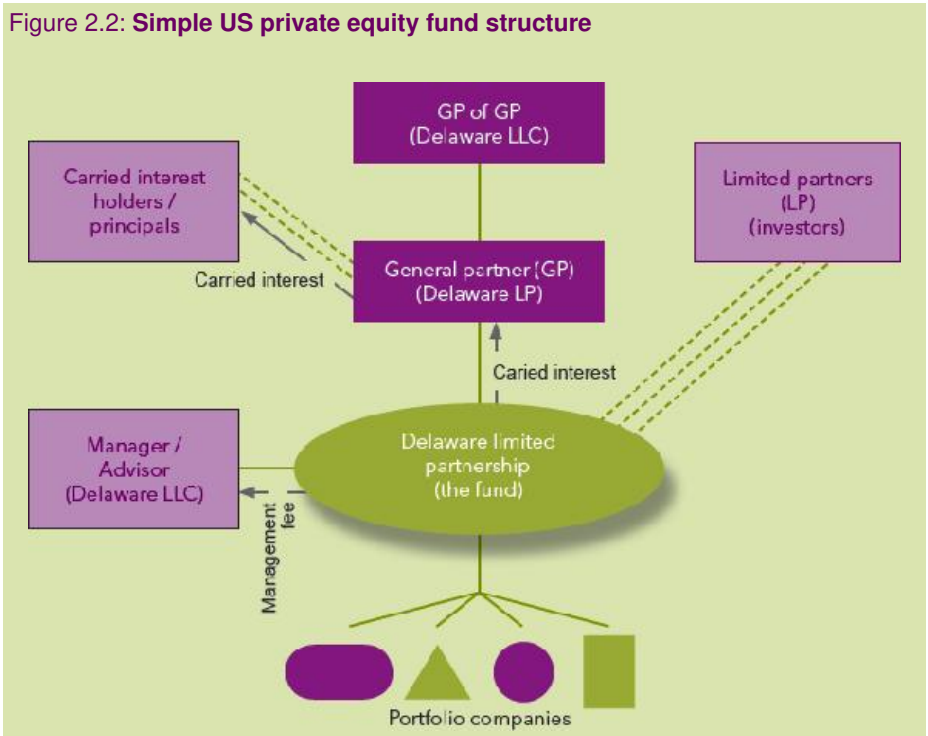
depend on the legal form explained in more detail in [Chapter 21](#), but generally is kept simple due to the low level of transactions, that is, mainly the carried interest.

The next participant in the fund structure is the manager, which is a separate entity within the structure, typically organised as a limited company or an LLP.

Accounting for the manager takes more time because there is a typically high volume of transactions, relative to the fund, as all the staff, including the investment professionals, are positioned at this level, so it usually involves payroll, varied expenses, including deal costs, the management fees/advisory fees passed on by the GP, transaction and other similar fees. More details are provided in [Chapter 21](#).

Typical US fund structure

[Figure 2.2](#) presents a simple US private equity fund structure, which is more or less similar to the UK structure. The following sections highlight some of the major differences from the UK structure.



Limited partnership

This could be a Delaware limited partnership, as in the example cited in [Figure 2.2](#), or a limited partnership domiciled elsewhere in the US. As for an English or Scottish partnership, the tax transparency is the most important feature. A Delaware limited partnership, unlike an English limited partnership but similar to a Scottish limited partnership, has a separate legal personality from its partners.

In terms of accounting, similar to the English partnership, the accounts are prepared at this level.

Limited partners

The commitments are different from the English partnership; the LPs in a US partnership make only capital (equity) commitments. Otherwise, it is broadly similar to the English structure.

General partners

The GP in this structure is also set up as a Delaware limited partnership and is similar to the UK structure. The distinction here is that the GP is the recipient of the carried interest, unlike the UK structure, where, for tax efficiency, there is a separate entity (the FP) set up to receive the carried interest. However, participation in the carried interest by the principals in a US fund can also be structured one level up or may involve additional entities with more sophisticated structuring, which would add another level of complexity.

Manager

This is similar to the UK structure, set up as a separate, but affiliated, entity, and organised as a limited liability company (LLC).

Master-feeder fund structures

Fund accountants who are familiar with the workings of a vanilla structure are often bewildered by slightly more complicated master-feeder fund structures. These involve a master-fund vehicle, organised as a common-law partnership in one jurisdiction for flexibility and familiarity, and one or more feeder or parallel funds, which could be organised as partnerships in one or more different jurisdictions or as a corporate-fund vehicle. The aim of this structure is to cater to particular investor groups with specific tax and/or regulatory requirements that cannot be accommodated through the main fund. Master-feeder fund structures appear in both US and UK funds.

Types of funds and similarities and differences in terms of accounting

The main types of traditional private equity funds, depending on the investment stage and strategy are buyouts, venture capital, early stage or growth capital and development capital. In addition, depending on the underlying assets in which they invest, there are different types of funds, which focus on investments in real estate, infrastructure, mezzanine, distressed/special situations, and funds of funds can focus on a broad range of investment strategies. There is also another division, for funds of funds, depending on whether they invest in recently launched funds or in established funds, that is, primary or secondary funds.

Buyout funds

It is assumed that a buyout fund is a classic example of a private equity fund that other types of funds can be compared to. Buyout funds are usually ordered in four different categories depending on the size of the fund – small, mid-size, large and mega buyouts. According to the categorisation in a Preqin research report on the performance of mega, large, mid-size and small buyout funds, for 2005-2008 vintage years, small buyout funds are ≤\$500 million (commitment), mid-market buyout funds are between \$501 million and \$1.5 billion, large buyout funds are between \$1.5 billion and \$4.5 billion, and megasize funds are above \$4.5 billion.⁷

Buyouts, similar to development capital, target more mature, established companies that generate operating cash flows. They usually consider a company's track record, for example, three to five years of accounts, but, unlike development capital, they look to acquire a majority stake in the company so that they can have overall control and have a say in how the company is managed, and therefore make decisions that will hopefully lead to an increase in value of that company and enhanced profits on exit. Before the global financial crisis, buyout funds were typically structured as leveraged buyouts (LBOs), geared with acquisition debt and related finance, but during the financial crisis, since the bank financing has become more restricted, a new trend has developed, namely the overall level of leverage has dropped.

Throughout, I describe the accounting for private equity mostly with a traditional buyout fund in mind. However, there are more similarities than differences and so, in terms of accounting at the fund level, this is applicable to all or most of the other funds, unless mentioned

otherwise.

Venture capital funds

Venture capital (VC) funds invest in companies with high potential that are in the seed (concept) stage, start-up (within three years of a company's establishment) or early stages of development. An important distinction, therefore, between buyouts and VC funds is the developmental stage of the portfolio companies into which they invest, and also VC investments are often in technology-related companies, for example, biotechnologies, information technology, software or telecommunications. Therefore, they feature a higher level of risk associated with the uncertainty of the product/technology development, often with the product/technology pending approval or patent. A further distinction is the size of the investee companies, with VC funds tending to invest in small enterprise value companies, while buyout funds invest in companies with large, sometimes very large, enterprise value. As a function of the size of the deals involved, the size of the VC funds themselves is also much smaller than the size of the buyout funds. Another important distinction is the level of control; unlike buyouts, VC funds, with few exceptions, usually do not have control over the investee companies. One final important distinction is that VC funds rarely use leverage, compared to buyouts, and particularly LBOs.⁸

Real estate funds

It is a common misconception that the accounting processes for real estate funds are significantly different from those of private equity funds. As long as they are structured as limited partnerships, at the fund level, there are more similarities than differences. The major difference is obviously in the underlying asset as these funds invest in real estate instead of private companies – this would be the key difference in their accounting treatment. However, this key difference is at the underlying-asset level.

Infrastructure funds

Similar to real estate funds, the accounting and the fund processes at the fund level are mostly the same as those for a buyout fund, with differences predetermined by the specifics of the underlying asset. Common examples of infrastructure assets include ports, airports, bridges, tunnels, toll roads, railway infrastructure, utilities (including

water, gas and electricity generation and distribution), telecommunications, wind farms, schools, hospitals, prisons, defence assets or any other asset that can be qualified as infrastructure.

Funds of funds

Private equity investments can be divided into two main streams – direct investments, when the fund invests directly into the underlying portfolio companies, and fund investments, when the fund invests into another fund that has direct invests, known as a fund of funds. The most important accounting implication for a fund of funds is that it is one level above company investing, in other words there is the added complication of another layer added to the picture. Some funds prefer to keep it simple and only track the investment in the investee fund, but others want to have a better understanding of what is happening at the level of the underlying portfolio companies that the investee fund invests into, and track that information.

This additional layer of information that a fund of funds needs to obtain from the investee fund can sometimes present a challenge and there are different approaches to tackle that challenge. These range from a more relaxed approach to wait until the next quarter and reflect the information with a one-quarter delay to the more aggressive approach of chasing the investee funds and/or their administrators to obtain the information earlier, even if that information is not fully accurate and may not be available for all the portfolio companies.

Secondary funds

Investment in private equity is illiquid in the sense that there is no quoted market for limited partnership interests in private equity funds. Although this is considered by some to be an attraction – arguably the plummeting capital markets in the wake of the global financial crisis might seemed to proven this point – for many investors the illiquid nature of private equity funds is one of the drawbacks of the asset class.

Fund investments are divided into primary and secondary investments. Primary investments are defined as capital being invested in a new fund, while secondary investments are defined as such when there is a purchase or transfer of interest into an existing fund. Secondary funds provide the liquidity that is sometimes sought by investors. A secondary transaction would include an LP in a limited partnership seeking to dispose of that interest, which could be for a number of

reasons including potential defaulting or simply a willingness to liquidate its investment. As far as accounting is concerned, secondary funds are no different from primary funds.

Mezzanine funds

Mezzanine finance can also form part of the capital structure of a leveraged buyout transaction. Mezzanine finance (or mezz as it often referred to) is named after the mezzanine floor in a building, which usually sits between two floors; in a similar manner, mezzanine finance involves hybrid instruments that sit between debt and equity, sharing characteristics of both. Mezzanine financing is basically subordinated debt or preferred equity securities that often represent the most junior portion of a company's capital structure, that is, senior to the company's common equity. Mezzanine instruments usually give the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back on time and in full. It is generally subordinated to debt provided by senior lenders.⁹

In terms of accounting specifically, the nature of these mezzanine instruments and the way they are treated and accounted for is the main differentiator.

Distressed opportunities/special-situations funds

Distressed or special-situations funds broadly invest in equity or debt securities of financially distressed companies. There are different investment strategies, but probably the most popular ones are distressed-to-control or loan-to-own, whereby the investor acquires debt securities with the aim of restructuring and converting that debt into equity and special situations. Turnaround strategies are also popular whereby rescue financing is provided usually in the form of debt and equity to companies facing financial challenges. However, there are also other strategies where portfolios of under-or non-performing debt, for example mortgage-backed securities or bonds, are acquired at huge discounts with the expectation of recovering a proportion larger than the discount.¹⁰

Accounting specifics for these funds are determined by the nature of the financial instruments acquired, but sometimes, particularly when the 'effective interest method' is used, the calculation model, rather than the accounting itself, can become a bit more complicated.

Summary

In this chapter, I have discussed some typical legal structures with the limited partnership as the most desirable legal form and contrasted a UK limited partnership structure to a US limited partnership structure with their similarities and differences which impact the accounting. I have also discussed the main types of private equity funds, from the relatively small-size venture capital funds and buyout funds (small, mid-market, large and mega funds) through to real estate, mezzanine, distressed opportunities/special situations and infrastructure funds to the secondaries and funds of funds, which all have more similarities than differences in terms of fund lifecycle, mechanics and accounting; the main differences are due to the underlying assets that these funds invest in.

Now that you are more familiar with the different fund structures and types of funds, in the next chapter I'll address the debate about why private equity accounting is different from accounting for other entities.

¹ The Debevoise & Plimpton European Private Equity Handbook 2004, Debevoise & Plimpton

² Offshore Limited Partnerships as Investment Funds, Patricia Allen, Ashurst.

³ For more information see *Laerstate BV -v- HMRC: corporate residence*, Ashurst Tax Newsletter, September 2009.

⁴ Having a separate legal personality has a 'blocker' effect, if an English partnership that does not have a separate legal personality is used by funds of funds, their investors would be treated as direct investors in the underlying investee/portfolio funds.

⁵ A limited liability limited partnership (LLLP) is essentially a limited partnership that offers a limited liability

⁶ English partnership law does not allow for the LPs capital (equity) contributions to be returned prior to the partnership's dissolution. If any part of the capital contributions is returned to an LP, that LP will lose its limited liability status proportionately to the returned capital contribution.

⁷ Preqin.

⁸ The PEI Fundamentals Series: Private Equity, Garry Sharp, Kelly DePonte and David Huckfield, PEI.

⁹ BVCA Private Equity and Venture Capital Performance Measurement Survey 2009, BVCA, PriceWaterhouseCoopers and Capital Dynamics.

¹⁰ Private Equity as an Asset Class (Second Edition), Guy Fraser-Sampson, John Wiley & Sons, 2010.

Why is private equity accounting different?

By Mariya Stefanova

This chapter discusses:

- The ways private equity accounting is different from accounting for other investment types
- Factors contributing to the uniqueness of private equity accounting, including:
 - ♦The preferred legal form (limited partnership and equivalents) and its specific allocations and allocation rules
 - ♦Limited partnership agreement (LPA)
 - ♦Fund purpose, activities and structure
 - ♦Investors' needs for financial reporting information
 - ♦Accounting frameworks and the 'investor-defined accounting framework' (LPA GAAP)

Introduction

Accounting for a private equity fund (and the other entities within the fund structure described in **Chapter 2**) is quite unique – not that accounting rules do not apply, they certainly do, but due to the fact that when accounting frameworks are defined, the standards-setters usually do not write them with private equity in mind (of course there are exceptions, such as US GAAP¹), and therefore some modifications to these rules and accounts formats are required in order for those accounts to be useful to their user – mostly the investors.

So, what is so unique about private equity accounting that sets it apart from accounting for entities of other types of investment vehicles and

other industries? If you are new to private equity you will be able to answer that question by the end of this chapter.

In a nutshell, there are five major differentiators that separate private equity accounting from accounting for entities of other industries and other types of investment vehicles:

- 1.The legal form – a limited partnership with its different investor classes (LPs, GP and FP) – and the way that this legal form is used to cater for the specific needs of the asset class.
- 2.The fund terms laid down in the limited partnership agreement (LPA).
- 3.The purpose and nature of the activities of the private equity fund.
- 4.The needs of the main users of the financial statements – the investors and their reporting requirements.
- 5.A unique accounting framework used only in this asset class – the ‘investor-defined accounting framework’, also called LPA GAAP (Generally Accepted Accounting Principles) which is still used in certain jurisdictions (for example, the UK).

The combination of these five factors, which are explained below one by one, makes private equity accounting unique and difficult to understand, at least at first, by accountants from outside of the asset class. This guide sets out to give the reader, in a systematic and comprehensive way, an insight into the mechanics of private equity accounting.

Legal form – limited partnership (or equivalents)

As explained in **Chapters 1 and 2**, a limited partnership (fund for joint account or other similar forms) is the preferred legal form for private equity funds. The ways in which that legal form is used to cater for the needs of the asset class, particularly the arrangement of the different classes of partners (limited partners (LP), general partner(s) (GP), founder partner (FP)), with different rights and responsibilities, are the framework for the accounting and reporting that dictates the layout of the accounts, how the information is recorded and what level of analysis is used.

Allocations and allocation rules

The first thing to bear in mind is that, in a limited partnership, investors (LPs) have an interest in the partnership. The same logic applies to a

corporate form, but instead of interest in a partnership, investors have shares. There are other types of partner. A GP acts in its capacity as a GP with its responsibility to manage the fund, but it can also be an LP/investor. In a UK partnership there may be an FP, which is basically a carried interest partner (CIP) that can act in its capacity as such, but also, similar to the GP, may act in its capacity as an LP/investor; these different entities in the fund can be referred to as 'classes of partners' (but sometimes I may refer to them as 'classes of investors'). A basic premise for the preparation and presentation of the partnership's financial statements is to reflect the interest of each class of partner (or shareholders in a corporate form) in the net assets of the partnership at each reporting date, or in other words the share of each class of partners in all the partnership's assets, liabilities, income and expenses (net income) and gains or losses.

The aim is also to present the return (understand the total profit & loss) by partner class, as well as by individual non-managing partner/investor. Therefore a fund's accountant needs to be able to track transactions and identify balances at the partner level, which is achieved by recording the transactions at that level. All the partners – LPs, GP and FP – have certain functions, rights and responsibilities within the structure, as explained in more detail in [Chapter 2](#). Following that logic, when recording transactions that stem from those functions, rights and responsibilities, these transactions should be allocated to each partner; this then allows for individual reporting on each partner in terms of its share in the assets, liabilities, income, expenses and gains or losses which is ultimately their share in the net assets or net asset value (NAV).

From the drawdown to the distribution, from the simplest fund expense or the income from interest on loan notes to the capital gain or loss on realisation of investments, the total amount of each of these transactions must be allocated to each individual partner in a certain way. This process is called 'allocation' and the ways in which accountants allocate those amounts to each partner is by following certain rules that are usually stipulated in the limited partnership agreement (LPA) – they are called 'allocation rules'. Allocations and allocation rules are explained in more detail in [Chapter 16](#).

An example of how the limited partnership, as a legal form, and the way in which it is used to cater to the needs of private equity is represented in specific sections of the financial statements, that is, the bottom part of the profit and loss/income statement where the net income and gains (losses) are allocated to classes of partners. Another example is the bottom part of the balance sheet – the

partners' accounts with the capital contribution account, loan (contribution) account, income account and capital (gains) account, which is further detailed in the statement of changes in partners' accounts (the 'capital account').

These three elements of the private equity fund financial statements – bottom part of the balance sheet, bottom part of the profit & loss and capital account/partners' accounts – are the most prominent examples of how the concept of allocation to individual partners materialises in the financial statements.

The uniqueness of the asset class, fund mechanics and lifecycle and the way performance is measured in private equity are discussed in the following section.

Limited partnership agreement

The second contributor to the uniqueness of private equity accounting is the terms stipulated in the LPA, which is an essential part of any fund accountant's toolkit. As explained in [Chapter 2](#), the second (although not by importance) crucial document for the fund accountant to understand, after he or she is familiar with the fund structure, is the LPA. Almost all the answers to questions that a fund accountant may have can be answered by reading the LPA. These questions will typically comprise:

- What is the accounting period?
- What reports need to be provided to the investors and when should they be provided?
- How is money drawn down and distributed from/to the partners?
- How is the waterfall/carried interest calculated?
- When and how should the partnership be dissolved?

A comprehensive explanation of the LPA terms for the fund accountant is provided in [Chapter 4](#).

Fund purpose, activities and structure

As outlined in many LPAs, the purpose of the private equity fund can be described as: 'Carrying out the business of an investor to identify, research, negotiate, make and monitor the progress of and sell, realise, exchange or distribute investments.'² These investments include ordinary shares, preference shares, debentures, loan stocks and other securities, convertible loan stock, options and warrants in

private equity transactions in accordance usually with an investment policy, with the principal objective being to provide partners with a high overall rate of return by means of both income and capital growth. Seeking long-term capital appreciation is often stated as the primary purpose of the partnership.

In addition to the purpose and the activities of the fund, it is important to remember the obligations of the fund accountant do not end with the preparation of the financial statement for the fund; accounts also need to be prepared for the other entities which are part of the fund structures explained in [Chapter 2](#).

Accounting at the fund level

The purpose of the private equity fund and its activities in fulfilling that purpose predicate the content and the layout of the fund's financial statements and the applicable accounting standards under the chosen accounting framework. For example, the purpose and the activities of the fund – long-term capital appreciation and investment activities, respectively – would predicate the presentation and the classification of the most important item on the balance sheet, this is, investments.

Since the purpose is long-term capital appreciation, private equity investments would be classified as long-term, fixed assets, as opposed to a hedge fund's investments, for example, which would be classified as short-term, current assets.

In the profit & loss, the following categories all reflect the investment activities of the fund:

- Income (including dividends from the underlying companies and interest from loan notes).
- Acquisition costs (whether charged to the profit & loss or capitalised, depending on the accounting framework and/or the accounting policy).
- Expenses (including management fees, due diligence fees, tax advisory fees, legal fees and administration fees).
- Revaluation (whether in equity/revaluation reserve or through the profit & loss depending again on the accounting framework and/or the accounting policy).
- Gains or losses on realisation of portfolio investments.

In the cash-flow statement (or statement of cash flows), cash flows from investment activities, for example, a dividend from portfolio companies or interest from loan notes are presented in the operating

activities as that is the main business of the fund. This differs from a manufacturing company, for example, in which the cash-flow statement items such as dividends or other similar income from subsidiaries or associates would be reflected in the investment activities.

As a culmination of the investment activities, the presentation of investment schedules and schedules of acquisitions and disposals of investments (where presented separately), with its level of detail, is probably the purest reflection of the fund activities. Activities such as drawdowns and distributions are reflected in the statement of changes in partners' accounts (or equivalents depending on the accounting framework).

In addition, subjects such as consolidation are also a reflection of the activities of the fund. On this point, however, private equity accounting experts almost unanimously agree that it is not meaningful for investment companies and should be avoided (where possible) by all means, whether by official exemptions or carve-outs in the standards or by simply stating a departure from that part of an accounting framework (for example, International Financial Reporting Standards (IFRS)) where consolidation is still unavoidable as of the time of writing the book, as part of the existing standards (more on consolidation and the forthcoming changes in IFRS in [Chapter 17](#)).

Finally, specific phenomena in private equity such as carried interest or priority profit share (in UK funds) will also be reflected in the fund accounts, further adding to their uniqueness (more on that in [Chapter 14](#) and [Chapter 12](#)).

Accounting for related entities

When discussing the subject of private equity accounting, it is important to remind ourselves that there are also other entities within the fund structure for which accounts need to be prepared. The most important of these entities are the GP, FP (where applicable), the manager and any co-investment/parallel vehicles.

Accounting for co-investment/parallel vehicles is not very different from the main fund accounting. These vehicles are usually set up as another limited partnership, which co-invest, that is, invest alongside the main fund, typically in the same investments, but on a smaller scale and usually under more favourable terms. They might be vehicles set up for the benefit of the employees of the manager or for

the benefit of 'friends and family'.³ This is why they are often affectionately referred to as friends-and-family funds or vehicles.

GP accounting typically has a very low volume of transactions and the accounts are often prepared on an annual basis mainly for the purposes of tax and statutory filings. The only significant transactions are the management fee (priority profit share (PPS) where applicable), which ultimately will have a zero effect on the profit & loss as it will usually be passed on to the manager that is effectively managing the fund either as management or advisory fees.

Apart from that, there will be some expenses such as, for example, audit fees, administration fees and other professional fees, as well as some filing or other minor fees. If there is no carried interest partner set up as a separate entity, the carried interest will also be accounted for in that entity later in the life of the fund.

Similar to the GP, the carried interest partner – the FP (if set up as a separate entity) – will have a low volume of transactions, with only the carried interest and some minor expenses (again for audit fees, administration and other professional fees) being accounted for in that entity. However, the allocation of the carried interest to individual carried interest partners may sometimes become complicated and may involve complex models and calculations to incentivise the individual carried interest partners.

Accounts for the manager would usually involve a high volume of transactions with a great number of expenses, including payroll, travel and subsistence expenses for all members of the deal team, and all kind of other expenses typical for a standard (non-investment) company. This entity is usually not particularly profitable for a fund administrator as it involves long hours of posting expenses and trying to track and report on them using different criteria, for example, by deal, location and cost centre. In terms of income, the main income comes from the management/advisory fee derived from the fund, together with transaction, advisory, monitoring/directorship and other investment-banking-like fees earned from the portfolio companies.

Accounting at the SPV level

Accounting at the special purpose vehicle (SPV) level is another aspect specific to private equity accounting. What is an SPV? The short answer is that an SPV is an acquisition vehicle constructed in a tax-efficient manner in relation to the acquisition and holding of

portfolio companies. With reference to SPV accounting the definition can be broad-ranging: sometimes it is straightforward with a low volume of transactions and sometimes complex and labour-intensive, depending on the specific SPV structure.

Investor needs: financial statements

The fund's financial statement format is further influenced by the needs and requirements of the main user of the financial statements – the investors. If there are specific rules for investment entities under the accounting framework adopted by the fund, for example, US GAAP, the accounting standards-setters would generally take into consideration the needs of the main user of those financial statements when setting their format, whether in a more prescriptive way for rules-based accounting frameworks or as a 'recommended practice' for principles-based frameworks.

If there are no specific rules, the accounting formats are moulded in the form of best practice to fit the LPs' requirements (although that will not be the only consideration).

Where there is flexibility (see the section below on flexible accounting frameworks), a GP will tend to listen to the LPs with respect to their reporting requirements, which was particularly evident in the tough fundraising conditions during the global financial crisis where LPs, particularly large institutional LPs, have been trying to shift the balance of power from the GPs to the LPs.

Those endeavours crystallised in the ILPA Private Equity Principles mentioned in [Chapter 2](#), which had incorporated some accounting templates (drawdowns and distribution notices as at the time of the publication and with more to come at a later stage) as explained in [Chapter 7](#).

In addition to the accounting requirements, investors usually impose additional reporting requirements. Some key examples:

- European Private Equity and Venture Capital Association (EVCA) reporting guidelines.
- British Private Equity and Venture Capital Association (BVCA) reporting guidelines.
- International Private Equity and Venture Capital Valuation (IPEV) guidelines.
- European Association for Investors in Non-listed Real Estate Vehicles (INREV) industry guidelines for property funds.

Investor reporting is explained in more detail in [Chapter 19](#).

Accounting frameworks and ‘investor-defined accounting framework’ (LPA GAAP)

The choice of accounting framework for the fund, where there is a choice, might be a complex decision, with many factors that could influence that decision. Some of these factors would involve investors’ preferences and/or requirements; others may involve cost and/or time considerations; some may be as a result of a more flexible framework being required with specific presentation and contents of the financial statements that do not fit any of the recognised accounting frameworks; and others may simply be looking to avoid greater levels of transparency.

For example, if the GP wants to avoid a more complex accounting with more rigorous and transparent disclosures, IFRS may not be a good choice of accounting framework with its consolidation requirements (as at the time of the publication) and thorough disclosures on financial instruments under *IFRS 7 Financial Instruments: Disclosures*. In fact, consolidation is probably one of the most common reasons for GPs willing to avoid IFRS.

In certain jurisdictions for certain types of funds where they can choose their accounting framework (for example, in the UK for funds structured as non-qualifying English limited partnerships), the choice of accounting framework might also be dictated by the LPs’ preferences and/or requirements; for example, if the majority of the investors are from the US, it may make sense to the GP to choose US GAAP as the fund’s accounting framework, in order to accommodate its investors, despite the fact that the fund is domiciled in a different (from the applied GAAP) jurisdiction (in the cited example an English partnership⁴).

As mentioned earlier in this chapter, most of the accounting rules under most of the recognised accounting frameworks (such as IFRS and UK GAAP) are not written with private equity (nor with investment entities in general) in mind and therefore they do not cater for many of the aspects specific to this asset class. A good example again is the consolidation under IFRS (for more information on consolidation, refer to [Chapter 17](#)) or the classification of partners’ interest (debt versus equity) again under IFRS (for more information, see [Chapter 7](#)). There is, however, for those jurisdictions that allow a flexible choice of accounting rules (the UK, for example), a clever solution to all these

problems, a phenomenon called ‘investor-defined accounting framework’ also known as LPA GAAP.

Investor-defined accounting framework (LPA GAAP) in the UK

The most popular choices of accounting frameworks are US GAAP, UK GAAP and IFRS, but the real favourite in the UK for non-qualifying partnerships is the so-called investor-defined accounting framework or, as fund accountants usually refer to it, LPA GAAP. It allows the GP to report under a flexible accounting framework ‘as agreed from time to time with the auditors’ to accommodate the specific requirements and the level of disclosure required by the investors and the GP itself. LPA GAAP allows the GP to report in a flexible way without stating a departure from a specific standard, which would be the case if reported under a recognised accounting framework. If LPA GAAP is adopted by the fund, the GP will be able to use whatever accounting policies it deems appropriate, for example, interest on loan notes recognised on a cash basis instead of on an accrual basis, which a recognised accounting framework would usually require, or to opt for non-consolidation.

Is the end of the LPA GAAP approaching?

This approach, however, might be under threat in the future for funds established in the UK which fall under the current definition of non-qualifying partnerships, due to the expected (at the time of writing) changes in the definition of ‘qualifying partnerships’ (for more information, see [Chapter 15](#)). Unless restructuring takes place, these changes may lead to many more funds being required to report under UK GAAP, which, from 2013 for most funds, would probably be *IFRS for Small and Medium-sized Entities* (IFRS for SMEs).

Summary

In this chapter, I have explained why and how private equity accounting is different from accounting for other entities – other types of investment vehicles and other industries. Among the chief reasons are the specifics of the preferred legal form, that is the limited partnership (and equivalents) and its constitution document, the ILPA, which stipulates all the rules of the fund (including the applicable accounting framework).

The LPA also stipulates the fund purpose, activities and fund structures with the preparation of accounts not only for the fund, but also for the other entities within the fund structure. I have also explained how the needs of the main users of the fund's financial statements – the investors – influence their format and level of disclosure. Finally, I have discussed the different accounting frameworks that define the accounting and the formats of the financial statements with a phenomenon called investor-defined accounting framework or LPA GAAP, which allows certain funds in certain jurisdictions (non-qualifying partnerships in the UK) to use flexible accounting and reporting rules; this phenomenon in the UK may soon come to an end.

Now that you are equipped with the next piece of the puzzle – a good understanding of why private equity accounting is different from accounting for entities of other types of investment vehicle and other industries — in the next chapter I will explain the LPA from an accounting point of view, which is a very important step before we can learn about the details of the fund lifecycle and the events at the different stages of this fund lifecycle and the accounting for those events.

¹ In US GAAP a separate set of rules applies – the AICPA Audit and Accounting Guide for Investment Companies, where accounting rules are put in the context of investment companies.

² Quote from an anonymised LPA.

³ Includes people and entities somehow 'close' to the fund/manager and might also include senior people at the LPs to 'sweeten' their investment in the main fund.

⁴ Note that in this example with the English partnership, the partnership should be a 'non-qualifying partnership' in order to be able to benefit from that flexibility; if the partnership is a 'qualifying partnership', it is required to prepare accounts under UK GAAP.

The limited partnership agreement explained

By Mariya Stefanova

This chapter discusses:

- The limited partnership agreement (LPA)
- The LPA structure, including its important clauses
- Where to look in the LPA
- Implications for accounting and reporting

As explained in [Chapter 2](#), the second crucial document for any fund accountant to understand, after familiarising himself or herself with the fund structure, is the limited partnership agreement (LPA).

What is an LPA?

The LPA is the key legal document for a fund set up as a limited partnership. It sets out the relationships, rights and responsibilities of each class of partners – limited partners (LPs), general partner (GP) and, where applicable, the founder partner (FP). The LPA essentially sets out all the rules of the fund. Anything and everything that a fund accountant needs to know should be in the LPA, although this is not necessarily always the case and that poses some challenges for fund accountants. Therefore, a fund accountant needs to have a thorough knowledge of the LPA of any fund he or she looks after.

The partners can agree whatever commercial terms they want, as long as the LPs do not take part in the management of the fund so as to preserve their limited liability status as explained in [Chapter 2](#) (with the slightly modified terms of and the extra limited liability shield for LLLPs,

explained in the same chapter). The problem with some LPAs is that they are often not detailed enough, whereas some of them lack detail about important aspects, such as allocations and even the waterfall calculation. In some cases certain parts of an LPA might even contain errors or omissions (with no offence to the lawyers intended, because they usually do a great job, but certain commercial, accounting and reporting aspects are sometime not fully addressed).

A universal wisdom that I learned from a seasoned fund accountant – a partner in one of the Big Four¹ – is that you should never let a lawyer put a formula in your LPA. This is precisely why fund sponsors, lawyers and accountants need to work together from the outset when the LPA is being drafted to avoid making changes to the LPA later in the life of the fund when, for important changes, there needs to be consent from the LPs. In my experience sponsors more frequently refer to their accountants or fund administrators from an early stage of the fund's establishment to ask for advice on certain practical aspects of the LPA.

The following section provides an outline of some of the key clauses in an LPA and should serve as an overview for new fund accountants; it contains the most important clauses for accountants to be aware of in order to do their job properly.

Parties

This section identifies the different parties involved with, and therefore bound by, the LPA. They are usually the GP, the FP (where applicable) and the LPs. Occasionally some LPAs include other specific parties with some special rights, for example, a government body or organisation participating in an infrastructure fund.

Introduction (or recitals)

The 'recitals' set out, by way of a general introduction, the reasons why the LPA is being entered into by the parties. In the recitals, there is some historical information that serves as a short overview of what has happened between the date the partnership was originally established and the date of the relevant version of the LPA, for instance, when the partnership was formed, who originally formed it, which partner retired and who was appointed instead. You will also find information on all the amended versions and the relevant dates on which the LPA has been amended, provided that you are reading a subsequent or final version. Information on initial contributions can also be found here, for

example, the FP's initial capital contribution as a carried interest partner and LP. If the final closing date has been extended, this information will be included here as well.

Definitions and interpretations

The definitions are extremely important because they contain some subtle details that can make a significant difference when applied in practice under the terms of the LPA. The following are some of the most common and important definitions, which have the largest impact on the accounting and reporting aspects of the fund, but this is by no means an exhaustive list. Furthermore, fund-specific definitions are sometimes encountered that need to be taken into consideration; obviously it is not possible to cover all of these here, but they are some that will serve you well in dealing with certain specific practical accounting aspects.

Accounting date and accounting period

If you are uncertain about the accounting date of the fund, typically the LPA will hold the answer for you in an unambiguous way, but what might be trickier sometimes is that in most LPAs the accounting period is defined as a calendar year and, although it may seem obvious, as fund accountants we often think of the accounting period more as a quarterly period, due to the industry best practice of preparing accounts and reports on a quarterly basis. However, in some cases, such as the calculation of the management fee/priority profit share (PPS) with the offsetting of transaction and other fees (which, for the management fees/PPS reduction purposes, are typically calculated based on the amounts for the previous accounting period; for more details on the management fee/PPS calculation, refer to [Chapter 12](#)), we need to consider that the management fee is applied in terms of accounting period which is again usually a year, not a quarter (and then pro-rated accordingly in calculating the quarterly/semi-annual GP drawings entitlement). Therefore, though this may seem like a basic term – an axiom that does not need defining – my advice would be that you always check your LPA definitions first rather than making assumptions about what certain terms mean.

Initial/first closing date and final closing dates

These dates are extremely important and often, although not always, they are mentioned in the final version of the LPA.² Most of the events in the life of the fund begin from the initial closing date (also called first closing date), for example, the management fee/PPS will start being calculated from that date. This is also typically the date from which the

investment period will start. The initial closing date is the closing date at which time the first investors are admitted to the partnership. There is usually a 12-month window between the initial and final closing dates to allow the sponsor to raise the targeted commitment.³ For more details on the closing process, please refer to [Chapter 6](#).

Investment/commitment period

This is another milestone in the life of the fund. It starts on the first closing date (or sometimes the first drawdown date, if this is different) and ends on whichever of the following occurs earliest:

- 1.The date falling five years (or any other number of years as stipulated by the LPA) after the first closing date (or sometimes the first drawdown date or the final closing date).
- 2.The date on which the total commitment has been fully drawn down.
- 3.The date on which at least a certain percentage of the commitment has been drawn down (for example, 75 percent or 80 percent, depending what is stated in the LPA) or a successor fund has been launched.
- 4.Another date nominated for early termination by the GP, for example, key-man termination or when applicable law or regulation or some unexpected significant event makes it necessary.

Following the investment-period end date, the basis of calculation for the management fee/PPS will change (for more details, see [Chapter 12](#)).

Partners

Partners are usually defined as the GP and the LPs and would typically exclude the FP; however, fund accountants should still check the definitions contained in the LPA. It is important to be clear about this definition when reading the LPA; for example, when reading the clauses on contributions and determining whether or not contributions (capital and loan contributions) need to be drawn down from different classes of partners – GP, FP and LPs – as different funds may have different arrangements.

ERISA partners

ERISA partners are benefit-plan investors — pension plans that are subject to the US Employee Retirement Income and Security Act (ERISA). These partners are subject to specific rules that the fund will need to comply with. To establish whether any of your LPs is an ERISA partner, you will need to check their deeds of adherence (subscription documents), where it will be clearly indicated. For more

information about the important implications for the fund with regards to those investors, see below in the explanations of the LPA clauses ERISA partner provisions.

Excused partner/investor

An excused partner is an LP that is excused from advancing loan contributions with respect to any portfolio investment. In other words, certain partners – for whatever reasons, whether legal, religious, moral or otherwise – choose not to invest in certain deals; for example, if there are Islamic investors, they may choose not to participate in deals involving alcohol, so the GP will not draw down loan commitments from these LPs with respect to a specific portfolio company that manufactures alcohol, and therefore, later on in the life of the fund, these excused investors should not share the profits/gains from those investments. The fund accountant must keep track of the drawdowns with respect to those excused investors and factor in the changed proportions in the distributions from those excused investors.⁴

Expenses

These are very important to fund accountants, and some subtle details which can make a huge difference must be appreciated; for example, you need to ensure that the relevant expenses are charged, according to the LPA, to the right entities within the fund structure – mostly between the fund and the manager/GP. For more details, refer to [Chapter 11](#).

Fee income, abort fees and net income (net income loss)

These are also very important for fund accountants to understand as they are involved in some important workings of the fund. They are explained in more detail in [Chapter 11](#), which focuses in detail on expenses and income.

Establishment⁵

This section will provide information on the constitution/registration of the partnership, including nature, purpose, name, principal place of business, commencement and duration/term, currency, further partners/subsequent investors (that is sometimes subject to a separate section), ERISA (venture capital operating company (VCOC)) requirements (again, it might be a subject to a separate section), advisory committee, co-investment vehicles (if any), side letters, registration in other jurisdictions and other as deemed appropriate.⁵

Nature

This clause, if available, provides information about the legal form of the fund and the law under which it has been established, for example, limited partnerships registered in England pursuant to the Limited Partnerships Act 1907. It may also explain the legal status of the partners, for example, the liability of the LPs is limited to their capital contributions and their outstanding loan commitments.

Purpose

In line with the investment strategy outlined in the private placement memorandum (PPM), this clause will reflect the description of the fund and its investment activities. The purpose is often set out as seeking long-term capital appreciation by acquiring, holding and disposing of securities. It may also specify the types of the targeted portfolio investments and/or the geographical area or sector.

Name and principal place of business

These are required by law, but it is also useful information for the fund accountant as this clause will provide information about where the fund is domiciled: whether it is onshore or offshore, an English or a Delaware partnership or based in Cayman, Jersey, Guernsey or somewhere else. The chosen jurisdiction of the fund plays an important role that the fund accountant needs to be aware of, so I would encourage you to read through that clause as soon as you become involved with the fund.

Term (or commencement and duration)

In this clause, the LPA will set out a specific period for the life of the fund, which may also provide for extending the life of the fund. As explained in [Chapter 1](#), private equity funds are fixed-life funds, with a typical term being ten years from the final closing date plus two successive one-year extensions. These extensions are at the discretion of the GP to provide for exceptional circumstances in which winding up the fund on the predetermined date will not be in the best interest of the LPs.⁶

Currency

This is obviously important to an accountant, so he or she can figure out what the functional and presentational currencies of the fund are.⁷

Subsequent (closing) partners/investors (or further partners)

A subsequent or closing partner/investor is an investor admitted to the partnership after the first closing date or an investor that increases its commitment after this date. This section is important to the accountant because it is related to two of the accounting processes that need to be run over the life of the fund – rebalancing and equalisation (for

more details see [Chapter 6](#)).

Partner transfers

This is a transfer of all or part of its interest by one LP to another partner or partners (LP or otherwise) with the prior written consent of the GP. Similar to rebalancing and equalisation, this is an important section of the LPA as it stipulates the rules of another accounting process with the same name – partner transfers – that fund accountants are responsible for. For more information, see [Chapter 8](#).

Commitment

This is the amount committed by a partner/investor to the partnership as set forth in the deed of adherence of that partner/investor. In the case of a UK fund, due to some specifics of the limited partnership law as explained in more detail in [Chapter 2](#),⁸ commitment is made up of an amount subscribed to it by an investor as capital/equity (the capital contribution) and an amount agreed to be advanced by an investor as a loan (the loan commitment). In a US fund the commitment will be made up only of a capital contribution.

Capital contribution and capital-contribution account

In a UK partnership, capital contribution is the part of the commitment that is contributed by each partner to the capital of the partnership, being typically equal to, in the case of an LP, 0.001 per cent (or 0.01 per cent) of its commitment, but different classes of partners may have different capital contributions (for more detail, see [Chapter 7](#)). The capital contribution will not be returned to the investors until the fund is wound up. This is specific to UK funds only and such a split is not found in a US fund where there are only capital contributions.

Each partner should usually have a capital-contribution account and the fund accountant will need to keep track of the balance of these accounts with respect to each partner.

Loans, loan commitment and loan account

In a UK partnership, this is the interest-free ‘loan’ advanced or agreed by an investor to be advanced (loan commitment) to the partnership, totalling 99.999 per cent of the investor’s commitment. Despite the fact that it does not have all the characteristics of a loan (that is, it bears no interest and it is repayable only to the extent of the funds available), since ultimately it does not entitle the holder of that loan – an investor – to participate in the residual net assets of the fund. Technically speaking under IFRS it is treated as a liability rather than equity, unlike the capital contributions which are treated as equity (for more information on the liability versus equity discussion, see [Chapter 7](#)).

Similarly, as with the capital contribution account, each partner will usually have a loan account and the fund accountant will need to keep track of the balance of these accounts with respect to each partner.

Capital account

A capital account is not to be confused with a capital-contribution account; it is in fact a capital-gains account where the capital gains/losses of the partnership are allocated to each partner.

Each partner should usually have a capital account and the fund accountant needs to keep track of the balance of these accounts with respect to each partner.

Income account

This is an account whereby the net income or net income loss (excluding capital gains/losses) is allocated to each partner.

Each partner should usually have an income account and the fund accountant needs to keep track of the balance of these accounts with respect to each partner.

In some funds, although the LPA may state that they need to keep separate capital and separate income accounts, the preference in terms of presentation in the financial statements (on the balance sheet and in the partners' accounts) may be to keep a single 'income account' that incorporates both net income/loss and capital gain/losses. In my experience, in some more complex funds this approach may save you some headaches, so consider carefully the pros and cons of presenting separate income and capital accounts as opposed to presenting a merged income account.

Drawdowns

These are the loans that are, from time to time, advanced to the fund by the partners, on an as-needed basis pursuant to a drawdown notice. Drawdowns are explained in detail in [Chapter 7](#).

Distributions

These are distributions of cash or in specie (an asset in its actual form) to the partners as the fund divests of investments later in the life of the fund and/or receives income from the investments. For more detail on distributions, refer to [Chapter 13](#).

Application of cash/priority of distribution (or waterfall)

This is how the cash received from disposal of investments or income from investments is applied; the order in which it is applied to different classes of partners (LPs, GP and FP). In private equity jargon, that

application of cash is called 'waterfall' as it describes the way that cash flows down to satisfy the rights of different partner classes. In a whole-of-fund carried interest arrangement, this usually happens in the following order:

- 1.To the GP for PPS.
- 2.To the LPs in return of their loan commitments.
- 3.To the LPs for preferred return.
- 4.To the GP/FP for catch-up (catch up is also carry).
- 5.In the 80:20 split (or any other split as 'stipulated by' the LPA) to LPs and GP/FP, respectively, as the 20 percent is the carried interest.

For more details on waterfall, refer to [Chapter 14](#).

Carried interest (or carry) and carried interest clawback

Beware of the carry. Usually there is no more complex area of the LPA than carry and a fund accountant needs to understand and apply it correctly. Errors are not acceptable, as this is likely to be an area that will be subject to scrutiny from LPs. Auditors will usually review and agree the carried interest model in advance of any carried interest payments. For more details on carried interest, refer to [Chapter 14](#).

Preferred return (or hurdle)

The preferred return can be considered as some kind of minimum 'guaranteed' (provided that the fund makes any money) return on the investors' money – the loans advanced by them. It is also called the hurdle – the reason for this term is that carried interest starts kicking in only past that hurdle. Basically, after the LPs are repaid their loans and on the top of them receive the preferred return, all the proceeds/profits after that are split 80:20 (although it could be any other proportion as stipulated by the LPA) – 80 percent to the LPs and 20 percent (that is the carried interest) to the carried interest partner (CIP).

Preferred return is typically 8 percent per annum and is calculated, on the daily balances of the loan outstanding (usually excluding the loans used for bridge/temporary investments), compounded annually as the exact date of compounding may vary (for example, in some funds it is December 31, in others it is on the anniversary of the first drawdown) and is calculated for each drawdown from the drawdown dates (the date when the money is due to the fund) specified in the drawdown notices until the dates distributions are made.

Catch-up

Again, this concerns the application of cash – the waterfall. It is called

a catch-up because it is designed so that the CIP – the GP or FP as the case may be – can catch up with the LPs after the return of the loan and the payment of the preferred return. As explained in the paragraph above, the catch-up is simply an accelerated carry. This should result in the cumulative amount distributed to the CIP being equal to 20 percent (in an 80/20 split) of the cumulative amount distributed so far under the preferred return and this catch-up clause, which, if you gross it up, is exactly 25 per cent (for the same 80/20 split) of the preferred return. For more details on carried interest, refer to [Chapter 14](#).

Management fee/PPS

With this key section of the LPA, it is important to establish the exact nature of the management fee structure, whether it is a simple management fee or a management fee structured (for tax reasons which is typical for UK funds) as a PPS, as this will predicate how you need to account for it – whether as a charge to the profit & loss (if simple management fee) or as allocation of profit (if structured as PPS). For detailed information, refer to [Chapter 12](#).

Allocations and allocation rules

When an accountant refers to allocations, it means allocation to different classes of partners (LPs, GP and FP) and individual partners/investors. The ultimate purpose of the allocations, as explained in [Chapter 3](#), is that a share of the net assets of the partnership to be allocated to each class of partners and to each individual investor. In the LPA allocations are mentioned with respect to cash (drawdowns and distributions) and with respect to (remaining) profits and losses (net income/loss, capital gain/loss), and they are usually described in two different sections of the LPA. The allocation rules in a more complex fund could be different for allocation of cash and allocation of profits/losses. For detailed information on allocations, refer to [Chapter 16](#).

Books, records and reporting to partners

This is obviously an important section for a fund accountant, which contains information on the applicable accounting framework/GAAP, audits, investor and tax reporting, verification of carried interest, deadlines with regards to the annual and quarterly accounts⁹ and any other reports.

Investments, investment activities and investment restrictions

These are obviously extremely important to the GP but less so to the fund accountant, as long as they are not part of a calculation or accounting for investments as is the case with bridge investments. For

more information, refer to [Chapter 9](#) which provides a detailed view on investments.

Bridge investment/temporary investment

Bridge investments are investments of a temporary nature, typically held for less than 12 months. These usually occur when the fund holds cash, pending investment in portfolio investments, distribution, funding or payment of the management fee/PPS and other expenses. The practical implication for a fund accountant is that they are excluded from some calculations, for instance, from the calculation of preferred return and the catch-up. In addition, amounts used to fund bridge/temporary investments are redrawable, as they are considered to be a 'quick flip' and not in line with the main investment policy of the fund.

Follow-on investment

A follow-on investment is an amount invested in a portfolio company to preserve, protect or enhance the fund's prior investment in such company. These are determined solely by the GP in its discretion when it deems them appropriate or necessary.

Private placement memorandum/information memorandum

The private placement memorandum (PPM) is the information document relating to the private (non-public) offering/placement of interests in the partnership; in other words, it is a marketing and information document that the private equity sponsor uses during the fundraising process. The PPM is basically the counterpart of the prospectus used in public offerings.

Deed of adherence/subscription documents

The deed of adherence is a subscription document that is connected to the admission of an investor to the partnership, which is an important legal document for any fund investor.

Side letters and side arrangements

Side letters or side arrangements offer amendments or variations to the terms of the LPA that are legally binding for the GP and are entered into for the benefit of an investor. They establish rights under, or supplementary to, the terms of the LPA or the deed of adherence previously signed by the investor, with relation to the operation of the business of the fund. Bottom line, these are used when special terms, different to the general terms of the LPA applicable to all the investors, are established for specific investors.

ERISA partners provisions

To avoid becoming subject to ERISA's fiduciary duties and

requirements, private equity sponsors with pension plan investors need to be very careful and aware of the exceptions used in their funds. There are basically two exceptions: the 25 percent exception if benefit-plan investors hold less than 25 percent of any class of equity interests in the fund; and the VCOC exception, if benefit-plan investors hold 25 percent or more of any class of equity interests in the fund. Most of the funds use the VCOC exception.

To qualify as a VCOC, a private equity fund must participate more in the management of the portfolio companies and satisfy two requirements: the so-called 50 percent test and the exercise test. The nature of private equity investments is such that the fund exercises management rights with regards to those investments, so the exercise test is not usually a problem. However, passing the 50 percent test can be problematic at the time of the first drawdown. To pass it, at least 50 percent of the fund's assets (excluding short-term investments, pending long-term commitments or distribution to investors – these are the bridge/temporary investments), valued at cost, must be invested in operating companies which are entities (other than VCOCs) that are primarily engaged in the production or sale of a product or service (other than the investment of capital) with respect to which the fund has management rights.¹⁰

In practical terms, this means that the fund must have made at least one investment before it can accept loan contributions for investments (capital contributions and loan contributions for management fees/PPS and fund expenses are allowed) from ERISA investors. This is why each fund that envisages having ERISA investors, needs to cater for their needs and include in the LPA special rules (for example, those governing the first drawdown) for them. The GP needs to monitor the fund to ensure it continues to qualify as a VCOC. The fund needs to pass the 50 percent test on the initial valuation date. This is the date on which the partnership made its first portfolio company investment and on a pre-selected date during each annual valuation period. If the fund fails the 50 percent test on the initial valuation date, it can never qualify as a VCOC. Later on, until it enters into its distribution period, the fund must pass the 50 percent test for each annual valuation period and VCOC certificates are issued to the ERISA investors each year.

If it fails the 50 percent test on any pre-selected annual testing date, it will permanently cease to be a VCOC. Special care must be taken if a fund has indirect investments through one or more holding companies, but that is for the lawyer to figure out; there is not much a fund accountant can do, but it is good to be aware of the challenges, as you

will probably be involved in issuing the VCOC certificates each year. Of more practical value for the fund accountant is knowledge of the rules governing the first drawdown, because you cannot afford to get that wrong.

Successor fund

The GP or any of its affiliates are not allowed to close a new successor fund until the earlier of:

- 1.the date on which a minimum percentage (for example, 75 or 80 percent) of the aggregate commitments has been contributed to the fund; or
- 2.the last day of the investment period.

Again, this clause is of more concern to the GP, but the fund accountant should also be aware of it because sometimes that event (launching a successor fund) may have practical implications (for example, changing the basis of calculation for the management fee/PPS).

Co-investment vehicles/funds, employee coinvestment funds and parallel funds

These are vehicles/funds created in connection with the main fund; they usually invest alongside the main fund in the same portfolio investments but on a smaller scale. They may be set up for the employees' benefit to incentivise them and other somehow-related individuals and entities (for example, executives of the LPs, relatives, friends or business partners of the principals of the fund), which is why they are sometimes affectionately referred to as friends-and-family funds.

Some final words

While this chapter addresses some very useful clauses contained in an LPA, there are also a number of other areas and potential issues addressed in it, such as powers, rights and GP duties, LP powers, appointment and removal of the GP, withdrawal of an LP, borrowing and financing, consents, meetings and votes, representations and warranties, advisory board, variation of an LPA, and termination of the partnership. All of these clauses are extremely important for all the participants involved in the fund structure, so much so there could be a whole book written solely on LPA terms.

For the purpose of this publication, however, I have focused on the practical areas where, from my experience in reviewing funds' financial

statements and in lecturing, fund accountants most frequently make mistakes and/or omissions in preparing a fund's financial statements. If you need any advice with regards to designing or interpreting an LPA, private equity specialist lawyers are the best people to talk to. Whereas fund accountants typically only deal with the already-signed LPA, our practical advice may be sought on certain areas in which we are involved and which can help to avoid potential mistakes – notably, allocations and carried interest.

Summary

In this chapter I have explained what an LPA is and how important it is for a fund accountant to be able to read and interpret its clauses. I have also outlined its structure and discussed a number of areas stipulated in the LPA that are important for fund accountants to understand in order to be able to prepare a reliable set of fund financial statements – areas where, based on a risk approach, it is more likely that the accountant will get wrong. Whether in reference to building a complex carried interest model or simply calculating the management fee/PPS quarterly entitlement of the GP or whether are wondering how to allocate the remaining profits, or some other area where fund accountants are involved.

Now that you have a sound knowledge of the rules of a private equity fund, which are defined in the LPA, the next chapter presents the lifecycle of a private equity fund with the main events at the different stage of that fund lifecycle that give rise to a number of accounting process that fund accountants are responsible for.

¹ The Big Four refers to the four largest global firms offering accountancy and professional services. This group currently includes Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers.

² Often after the final closing date, an amended and restated version of the LPA is issued.

³ That window does not necessarily need to be 12 months; it is entirely up to the GP to determine the length, taking into account the fundraising conditions alongside some other factors. It is therefore important to check the LPA rather than just assuming it is 12 months.

⁴ There are also other implications, each one of which will be explained in the relevant chapters of the book.

⁵ This section is sometimes known as the constitution of the partnership or operating provisions.

⁶ The period between 2008 and 2011 is a good example of such a situation; with inactive markets and low below-cost valuations, if there is no such provision for extending the life of the fund, the GP will have to fire-sell its last few investments in such market conditions to fulfil its obligation to wind up the fund which would lead to

unnecessary losses being incurred.

⁷ These terms are relevant in International Financial Reporting Standards (IFRS) terms, but will vary depending on the GAAP being used.

⁸ Investors in an English limited partnership are required to make capital (equity) commitments and loan (debt) commitments to the fund, while investors in a US limited partnership make only capital (equity) commitments. LPs are not allowed to be returned irrevocably, prior to the dissolution of the partnership, any capital commitments. If this does occur, the LP will lose its limited liability status.

⁹ The industry best practice for private equity funds, with respect to the deadline for annual (usually audited) accounts is 90 days after the year-end, and for quarterly accounts – 45 days after the quarter end.

¹⁰ What Private Equity Professional Should Know about ERISA's VCOC Requirements, Private Equity Newsletter, June 16, 2008, Davis Polk & Wardwell.

Fund lifecycle

By Mariya Stefanova

This chapter discusses:

- The different stages and sub-stages of the fund lifecycle
- What happens at each stage and sub-stage
- How accounting processes follow the fund lifecycle
- The accounting and reporting implications in brief at each stage

As discussed earlier in this publication, the typical private equity fund is a limited-life fund, sometimes referred to as a fixed-life fund, with a typical '10-and-2' term. There are a number of different stages starting from the idea to set up a fund and ending with the wind-up of that fund.

The fund lifecycle can be divided into three main stages: introduction, growth and maturity, as illustrated in [Figure 5.1](#) over the page.

Of course, the lifecycle of different funds might vary slightly, particularly at the early, introduction stage, and some of the stages will inevitably overlap, such as, for example investment and divestment, or drawdowns and distributions, but a typical private equity fund lifecycle will broadly follow these stages.

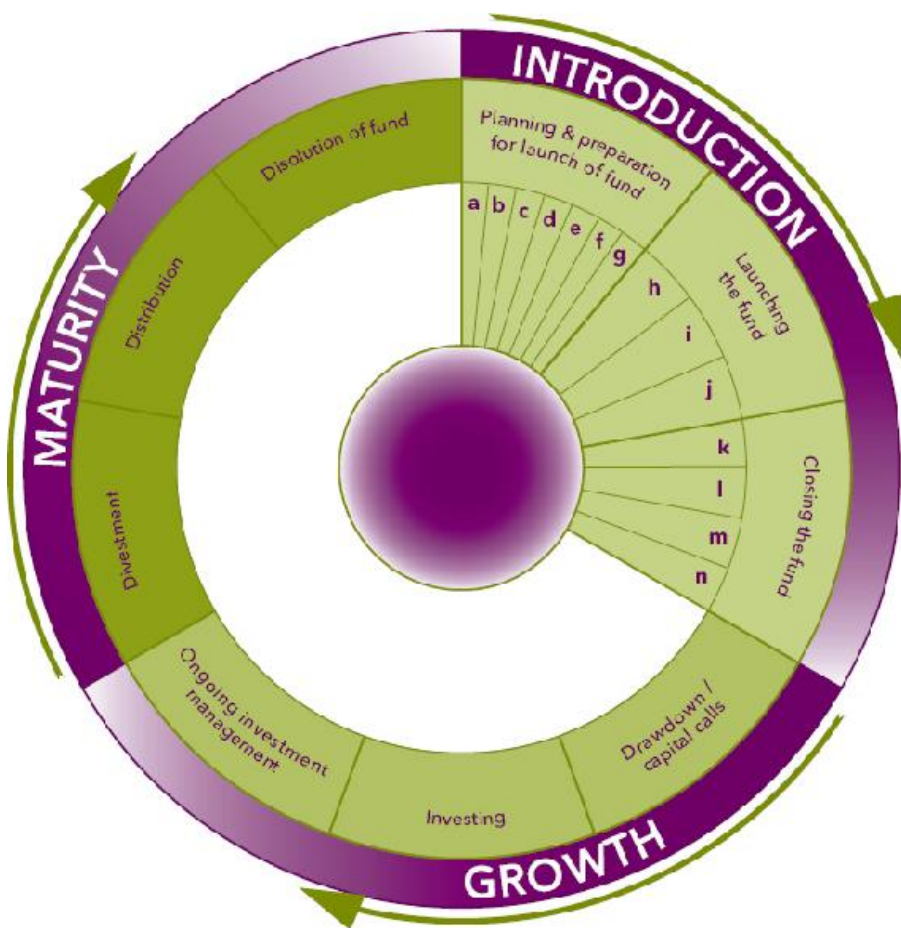
Introduction stage

When I teach accountants about the fund lifecycle, quite often the first question I am asked is who would set up a private equity fund? Accountants are extremely interested in the answer and I usually field lots of their follow-on questions and give examples to illustrate the process; I think that this helps accountants to better understand the whole process. So here is the answer to that question, or at least one of the many answers, explained with a hypothetical example, which is based on the many funds that I have seen while working as a fund

accountant myself or advising on different accounting solutions for various funds.

Setting up a fund, and particularly ensuring its success, is not an easy task and requires extensive knowledge of the private equity asset class, a good track record, determination, and, last but not least, good connections with limited partners (LPs). A typical mid-market buyout fund, ignoring the private equity funds that are part of big financial institutions, can often be set up by one or more senior executive(s) who spin(s) out of big financial institutions – investment banks such as Goldman Sachs, Lehman Brothers (before its collapse obviously), Barclays Capital, HSBC or private equity houses such as Permira, 3i, Terra Firma, CVC Capital Partners, The Carlyle Group or Kohlberg Kravis & Roberts. These individuals are usually senior professionals, for example, a managing director or vice president, who, for whatever reason, are willing to leave the big organisation and set up their own fund. They are likely to have a great deal of experience and knowledge about the asset class, a good track record and connections with LPs. One of the most prominent examples is Jon Moulton who co-founded Alchemy Partners 12 years before he left the firm in September 2009, after ongoing disagreements with his successor Dominic Slade.¹ In October 2009, Moulton set up Better Capital, which was subsequently floated on London's AIM in December 2009.² Of course, not every principal/founder of a fund would have Jon Moulton's experience, but the most successful ones would have many of the aforementioned requirements. Obviously, existing private equity midmarket firms also launch follow-on funds as well.

Figure 5.1: Private equity lifecycle



Key

- Drafting investment and limited partnership private placement memorandum (PPM)
- Identifying investment market
- Finalising the legal draft (e.g.)
- Identifying investors and first/initial closing to:
- Investors only
- Structuring the fund
- Drafting the conditions of the fund/draft

Source: Author

Hypothetical example of a new-fund launch

I will use a hypothetical example to further illustrate this. A managing director from Lehman Brothers – I will call him John Starbright – was left without a job after the collapse of the investment bank in September 2008. He decided to set up his own specialist private equity fund with a targeted total commitment of \$1 billion (minimum target

level of \$0.5 billion) to invest in Central & Eastern European telecoms companies, based on his asset class, sector and geography expertise.³ Let us assume that Starbright had a proven track record as one of Lehman's former star fund managers, known within the investment community as consistently delivering exceptional performance to his clients – predominantly institutional investors, such as US pension funds and endowments, and high-net-worth individuals.

He planned to attract some of his brightest colleagues from Lehman's to be part of his investment/management team. I will use this example to follow the whole process from the idea to the dissolution of the fund.

Planning and preparation for launch

Targeting investors and identifying investor requirements

At this preliminary stage, Starbright had to undertake a thorough research of the investment market, in order to identify and understand the needs of his potential investors – institutional, corporate and private – which always have to be taken into account during the fundraising process. There are six main areas in which the investors will typically be interested and he needed to plan his fund around those requirements: investment market; investment strategy; investment/management team; track record; fund structure; and terms and conditions of the fund.⁴

Investment market

First off, Starbright needed to establish if there were enough investment opportunities during the investment stage and potential exit routes during the divestment stage in the targeted marketplace – in this case, the Central & Eastern European telecoms investment market. He also needed to convince the potential investors that there was enough political, price and currency stability in the targeted geographical area.

Investment strategy

The next consideration, and probably one of the most important ones, is the investment strategy. Once Starbright had decided on the sector/industry and geographical area, which was predicated in this case by his own and his investment/management team's previous experience and knowledge,⁵ he also needed to decide on the investment stage, deal flow and deal-sourcing, investment decision-making, investment structure (whether majority or minority stake) and management approach (hands-on or passive).

Investment/management team

Many LPs consider the investment/management team to be the most important guarantee of success – the size of the team, previous private equity and/or other relevant experience, track record of that team (see below), the ability to add value, continuity and commitment, and even the incentive structure (carried interest structure).

Track record

Track record is the best historical measure of an investment/management team and it sets a benchmark for investor expectations of future returns. The track record of previous funds with the level of their historical returns (IRR and multiples), amount of money repaid to LPs, and the consistency and spread of returns is an indicator of success for a successor fund, and track record of the investment/management team, either individually or as a team, for a first-time fund. In this example, Starbright's track record, as well as the track record of his investment/management team of former Lehmans colleagues, who had been working successfully together as a team for years, was crucial to his success in attracting investors, due to the lack of track record for previous funds.

Structuring the fund

After securing a sound investment strategy and reliable investment team with a good track record, the next stage to plan was the fund structure to accommodate the needs of the potential investors that Starbright expected to take on board.⁶ A serious amount of tax planning and fund structuring usually goes into this stage, resulting in large tax advisory and legal fees respectively, but tax efficiency is very important to investors, so tax-planning and fund-structuring should be considered in detail at the outset. However, tax and legal advice is generally expensive so should be minimised where possible until a closing of the fund is imminent.

In practice, later on when the actual fund-structuring takes place, lawyers and tax advisers will first take into consideration the expectations of the fund-setter, in this case, Starbright. In the Starbright example they then considered the type and geography/domicile of the investors, which were mostly large US institutional investors and some European and UK corporate and high-net-worth individuals, as well as the geography of the potential investments. When these were all combined with a number of other factors, the lawyers and tax advisers then suggested a fund structure to accommodate the needs of the main investors, which may have included a master-feeder structure and appropriate selection of the fund's domicile – a choice of onshore or offshore.

Terms and conditions of the fund

Once all of the above had been decided, the next process to consider was the terms and conditions of the fund – it was now time for Starbright to engage lawyers to draft the limited partnership agreement (LPA). Alternatively, he could have been more cautious and waited until the closing of the fund was imminent. In general, if investors are happy with the investment strategy, track record of the management team and the fund structure, and are convinced that they can deliver good returns in a tax-efficient way, they will then be analysing the terms and conditions of the fund, which will be laid out in the LPA later on. LPAs are becoming increasingly important these days in the tough fundraising conditions and consequently general partners (GP) are becoming more accommodating.

Launching the fund

When Starbright was convinced of his fund's likely success, and had a fund structure and terms and conditions in mind, he was ready to launch his fund.

Drafting the information memorandum/PPM

For Starbright, drafting the private placement memorandum (PPM) was the next important step towards launching a fund. For all funds, the PPM is a marketing document (essentially a business plan), which sells the fund to prospective investors and should therefore cover all the investor requirements outlined above.

This includes a wide range of information, such as details about the management team and its track record, the investment strategy and process, and the legal, tax and commercial aspects of the fund, including a summary of the terms and conditions of the fund – term, management fees/priority profit share (PPS) and carried interest. The PPM is basically the counterpart of the prospectus for public companies.

Fundraising

Back to the example, with the PPM in hand and the decision made to go ahead with the fund, Starbright needed to decide on the timing of the launch and the marketing techniques to be used:

- Sending the PPM to potential investors and then following up.
- Conducting potential investor visits.
- Using a placement agent.

Finalising the legal details

In private equity funds, after investors give an indication of their interest (known as the 'soft circle'), it is then time to finalise the legal details, if this has not been done at an earlier stage. This includes finalising the fund structure and putting the terms and conditions into a proper LPA, so that these can be sent out to potential investors at the next stage.

Closing a fund

Commitments and first/initial closing

The next stage for Starbright was to listen to comments and feedback from potential investors – some positive responses resulted in verbal commitments. Starbright managed to secure commitments from ten investors, each with \$50 million tickets, which totalled \$500 million to invest in the fund (known as the 'hard circle'). In general, if the minimum target level has been achieved, a decision to close the fund potentially follows and the applications, followed by the deeds of adherence, can go out to investors. In Starbright's case he had successfully closed his fund. In private equity this is called the 'first closing' or 'initial closing'.

Related administration and accounting processes

When the first closing of a fund is declared, fund accountants become involved – either as an in-house function or as part of a third-party fund administrator. They will start recording investor commitments in preparation for the first drawdown.

At this stage, this is the time to send welcome letters to the first-closing investors.

As well as recording investor commitments and sending welcome letters, additional administrative processes need to be completed:

- Bank accounts need to be opened.
- The limited partnership register, statutory database for shareholders and directors at the GP need to be set up.
- Custody arrangements (if required) need to be made.
- Filing and accounting systems need to be set up.
- Templates for drawdowns, distributions, partner statements, financial statements and other reports need to be set up.

If the fund or other related entities, such as the GP or co-investment vehicles, are domiciled offshore or in another jurisdiction, the relevant arrangements need to be made and corporate secretarial (co-sec)

work must be delegated to offshore lawyers or fund administrators.

Client due diligence

In accordance with the relevant jurisdiction regulations, client due diligence (CDD) (the process previously known as ‘know your client’ or KYC) must be completed on all the partners admitted to the partnership. This function can be performed either internally by the GP or delegated to an external third party; for example, it could be outsourced to the fund administrator. Regardless of who undertakes the process, the fund should not be allowed to close until CDD is completed to ensure that none of the client funds are from a suspicious source, such as a result of money laundering.

Multiple closings

However, this was not the end of the story for Starbright. He still believed that he could achieve the targeted \$1 billion total commitment. In his LPA he had provided for a window of 12 months between the first and the final closings – a pretty standard clause, so he had a further year to find more investors to commit to his fund. Each time that he managed to secure commitment from a group of new investors constituted a subsequent closing until the first anniversary of the fund from its initial closing.

So, with further commitments in mind, Starbright had a one-year window to secure further commitments, after which point no more investors would have been admitted to the fund.

Related administration and accounting processes

In a fund with multiple closings, each time there is a new closing, the fund accountants will need to run a rebalancing process, and if there have been drawdowns between the closings, they will have to do an equalisation or a ‘true-up’ of the fund. These two processes will be explained in detail in [Chapter 7](#).

Growth stage

Drawdowns/capital calls

As explained in [Chapter 4](#), the commitment does not require all the money to be delivered on day one of the process but is rather a legal obligation for the investors to deliver money to the fund on an as-needed basis whenever investments are to be made or expenses incurred (or expected to be incurred) and obligations to suppliers or other parties to be met. These are called drawdowns or capital calls.

Related administration and accounting processes

In general, with the first closing, in addition to the welcome letters being sent to the investors, it is likely that the GP would send the first drawdown notice to call for the first management fee/PPS entitlement. This fee would cover the first closing and establishment costs, which have been advanced by the GP and need to be recovered from investors now, as well as probably some fund expenses that the GP envisages are likely to be incurred during the first quarter.

For each drawdown, reference to the LPA needs to be made, with respect to the rules governing the first and subsequent drawdowns; ERISA implications need to be taken into consideration, as explained in [Chapter 4](#). Detailed information on this process will be provided in [Chapter 6](#).

Investing

Over the life of the fund, particularly during the investment period, the fund is expected to make a number of investments in portfolio companies. As explained in [Chapter 4](#), the fund investment strategy may seek to generate significant long-term capital appreciation by investing in Central & Eastern European telecom companies as in the Starbright example cited above, through management buyouts, buy-ins, acquisitions, recapitalisations, growth-equity investments and related transactions. Investment strategy and restrictions, in line with the PPM and LPA, need to be observed at all times.

Related Administration and accounting processes

The investment process has significant implications for the fund accountants/fund administrators. Firstly, they need to decide on appropriate accounting policies and treatments with regards to the investments, depending on the adopted accounting framework. Secondly, valuations need to be done at certain times – whether internally or externally – and these valuations, again depending on the accounting framework and policy, need to be factored into the accounts and/or investor reports.

In addition, investments could be made directly, but they are likely to be made through tax-efficient special purpose vehicles (SPVs). Similar to the fund-structuring, depending on the investment geography and specifics, a lot of thought is put into the deal-structuring of each investment and certain rules need to be observed specific to each deal.

This would involve accounting at this level and the GP needs to decide who will perform that function; very often (but not necessarily) accounting at the SPV level is done where the SPV is domiciled – for example, if a Luxembourg SPV structure is used, very often the SPV accounting is done by a Luxembourg administrator), so that the local accountants can do all the tax and statutory filings. It could also be done by the fund's administrator particularly if it has offices across the globe with the relevant local expertise.

There may also be some leverage (debt funding) at the SPV level and bank covenants may need to be observed.

Ongoing investment management

Throughout the life of the fund, the GP will closely monitor performance of the portfolio companies. The fund will typically have acquired a controlling stake in each company so that it can have the freedom to make any management decisions. Furthermore, the fund will usually have representatives serving on the boards of directors or the supervisory boards of the portfolio companies. These representatives will work closely with the management and appropriately incentivise it to improve performance with the view of enhancing the strategic and economic value of the company, so that this value can be realised later on.

Related administration and accounting processes

There are no specific accounting implications connected to the ongoing investment management but, at this stage, as well as throughout the fund lifecycle, there is a number of administrative and accounting processes to be conducted, such as producing accounts, investor reporting in accordance with the LPA, valuations, IRR calculations, regulatory compliance, investor relations and tax reporting, for example, K-1s⁷ or other partnership returns, and tax and statutory reporting and filings.

Maturity stage

Divestment

A fund will typically hold a portfolio company for an average holding period of three to five years before exiting the investment. Possible exit strategies, depending on the nature and state of the investment and the market conditions at the time, include initial public offerings (IPOs), trade sales, recapitalisations, secondary buyouts and write-offs.⁸

Related administration and accounting processes

Divestment transactions need to be reflected appropriately in the accounts and reports. For more details, refer to [Chapter 9](#). Without reflecting these correctly and in a timely fashion, this will impact the fund economics

Distributions

Following realisations, there will be an incoming cash flow of realisation/sale proceeds, which will need to be passed back on to the investors in the form of cash distributions.

There will also be some periodic incoming cash flows from dividends and interest from the portfolio companies, but they are immaterial when compared to the realisation proceeds, so very often in practice, although there would typically be a clause in the LPA about the timing of the distribution of these proceeds (but there is also an element of discretion, exercised by the GP, embedded), the fund keeps hold of them and distributes them to the investors only when there is a more significant investment disposal or nets them off against the next drawdown (net drawdowns).

Related administration and accounting processes

These distributions need to be made in accordance with the LPA in line with the waterfall – order of distributions – as explained in [Chapter 4](#). This concept will be explained in even more detail in [Chapter 13](#). Distribution calculations need to be performed, distribution notices will be sent out to investors and cash transfers executed. There are different types of distributions, for example, income, capital, temporary and permanent, qualified, deemed, which need to be taken into consideration and reflected in the distribution notices. Distributions also need to be reflected in the financial statements through the partners' accounts. For more detail, refer to [Chapter 13](#).

Dissolution/windup of a fund

The final stage is marked by the end of the fund's life. Dissolution must be completed in accordance with the LPA provisions and the relevant jurisdiction's legislation, including returning the capital contributions to the partners – the 0.001 percent of the total commitment for a UK fund, for example.

Summary

In this chapter I have outlined the different stages and sub-stages of the fund lifecycle with the relevant events which the fund accountant is likely to be involved in: from the idea to set-up and the launch of a fund, through its growth stage; the investment period with the initial, interim and final closings, drawdowns, investing and on-going investment management; and its maturity, the divestment period with its distributions to finally wind-up the fund at the end of its life. For almost each of these stages there is an accounting process that you need to understand and be able to perform.

This chapter is the last introductory chapter that equips you with the tools to delve into the deep waters of private equity accounting and a prelude to the next chapters where each event typically involving a fund accountant is explained in a lot more detail. The next chapter will answer many of the question most new fund accountants have when they first start, but there would inevitably be questions and areas that could be addressed further as each accounting event can trigger an infinite number of questions when you start looking into detail. The multi-layered and specific nature of each LPA for specific treatment and understanding the subtle details and reading between the lines. I would say the answer would always be 'read and make sure that you understand correctly the intention of your LPA first'.

¹ Jon Moulton quits Alchemy, with brickbats for his successor, Costello, M., *The Times*, September 4, 2009.

² Jon Moulton to launch new investment fund Better Capital six weeks after quitting Alchemy, *The Telegraph*, White, G., October 18, 2009; Jon Moulton's Better Capital to raise £142m in Aim float, *The Telegraph*, December 15, 2009.

³ For the purposes of the example, I will ignore the impact of the financial crisis following the Lehman Brothers collapse, including fundraising conditions, plummeting valuations and lack of financing.

⁴ *The venture capital handbook*. FT Prentice Hall, Bygrave, W.D., Hay, M. and Peeters, J.B., 1999.

⁵ The fund does not necessarily need to select a specific industry and/or geography; it could be a generalist fund, investing in all sectors, geographical areas and all stages of development.

⁶ Starbright had probably approached some of his previous clients to scope out their preliminary thoughts on his new fund.

⁷ K-1 or officially called Schedule K-1 is a tax form (Form 1065) used by Partnerships (or S-Corporations) in the US to report (to IRS) a partner's distributed share of income.

⁸ Write-offs are, of course, not a planned exit strategy, but do sometimes happen.

06

Initial, subsequent and final closings,

rebalancing & equalisation

By Mariya Stefanova

This chapter discusses:

- What is a close or closing?
- What is a subsequent closing?
- Funds with multiple closings
- What are the implications of subsequent closings for investors?
- The process of equalisation
- The process of rebalancing

In [Chapter 2](#), I discussed the closed nature of the private equity funds and in [Chapter 5](#) I introduced the closing process, and now in this chapter I will discuss in more detail the accounting implications that result from subsequent and multiple closings.

What is a close or closing?

As a reminder, a close or closing is any date on which the general partner (GP) admits one or more additional (also called ‘subsequent-closing’) partners to the fund or that is any intake of new investors. On each closing, the GP can admit additional and/or subsequent partners to the fund or permit previously admitted partners to increase their commitments – both types are usually referred to as subsequent-closing partners.

Some pre-closing events

Before admission, any new investors will need to execute and deliver certain documents, instruments and certificates with the most important ones being an application for admission to the partnership and the execution of a deed of adherence, followed by a client due diligence (CDD) (formerly known as a KYC or 'know your client') process which could be performed by either the GP or delegated to an external service provider (for example, the fund administrator the GP has employed).

It is the GP's responsibility to make sure that the admission of any new investor will not result in a violation of any applicable law, not just in the fund's jurisdiction, but also in the investors', for example the Financial Services and Markets Act 2000 (FSMA) in the UK or the federal securities laws and the ERISA legislation in the US.¹

If it is a US fund or if there are US investors investing in the fund, chances are that there would be some provisions with regards to the admission of new investors about the Investment Company Act and the registration of the fund under that act; and the Advisers Act and the registration of the GP, the manager or any other affiliates as investment advisers under the act.²

Initial or first closing

The initial closing date, also called the first closing date, is the date on which the first investors are admitted to the fund. Very often that date is indicated in the amended and restated version of the limited partnership agreement (LPA) following that closing date, although sometimes if you are an external accountant and you are not involved in the administration, for example if the drawdowns and other processes are kept in-house by the private equity firm and you only prepare the accounts, it may take a little bit more effort to find out. But in any case you would need to know what the initial or first closing date is as most of the events in the fund's lifecycle start counting from that date.

Subsequent or additional and multiple closings

Subsequent or additional closing is a closing following the initial closing; here, reference is made to multiple closings when there is more than one closing, or in other words, when there is(are) subsequent closing(s) following the initial closing.

As usual, the first consideration for any fund accountant is to check the LPA. Typically there would be either a completely separate section, which might be titled with various headings including: subsequent-closing partners: further partners: admission of further partners; or additional limited partners. Alternatively, it could be a part of a section, for example, it could be in the same section as the partner transfers, called something such as transfers or subsequent closing partners. As explained below, there would usually be a timeframe for the subsequent closings.

A subsequent investor, also referred to as an additional investor or a further partner, is an investor admitted after the first closing date or any investor that increases its commitment (in which case such an investor will only be a subsequent investor in respect of its increased commitment).

Final closing date

The final closing date (in some LPAs it is referred to as the final admission date) is the final date on which additional/subsequent investors are admitted to the fund, or on which increased capital commitments are accepted from existing investors.

The timeframe within which the fund can have its final closing usually counts from the initial closing. Whereas 12 months is very common, 18 months has also become increasingly common during the financial crisis, so it is important to confirm the exact timeframe as it might be more or less than 12 months. I have seen timeframes including nine months, six months (which is not that common), but in tough fundraising conditions the timeframe might be set to more than 12 months.

The GP has the responsibility to determine the date and notify the investors about the final closing date. Similar to the initial closing date, the final closing date may be indicated in the amended and restated versions of the LPA following the final closing.

Documentation

What are the documents that you, as a fund accountant, would need to reflect the events that are to be recorded as a result of a subsequent closing?

- Once again, first you will need the LPA – the LPA provides all the

rules governing subsequent closings – and timing, conditions to be met, restrictions and equalisation calculation.

- Since what really is happening at a subsequent closing is accepting new investors or increasing the interest in the fund of existing investors, you will need the deeds of adherence/subscription documents. The deeds of adherence is basically a document according to which investors agree to adhere to the fund's LPA, which also contains some additional useful information for the accountant (for example, contact information, tax status, tax ID, whether the investor is an ERISA investor, and if K-1 is required if the investor is a US investors). In addition to that, CDD (formerly KYC) documents, W-8, W-9³ and other documents may be required.

What are the implications of subsequent closings for the investors?

There are a few implications of subsequent closings for the investors:

- The first implication is that subsequent investors are required to contribute to the partnership as if they have joined the fund on day one – on the first closing date – and therefore they will be sharing the benefits, that is, the distributions, in exactly the same way, as if they were investors that had joined the fund at first closing.
- The second implication stems from the first one, namely, if the subsequent investors are treated as if they have joined the fund on day one, then if there were any drawdowns between the initial closing and the relevant subsequent closing, a true-up is required and that true-up is called equalisation. The process of equalisation will be explained in more detail below.
- In addition to the equalisation, regardless of whether there were any drawdowns, another process is required, which is called rebalancing. The process of rebalancing will also be explained below.

Equalisation

As briefly explained above, the process of equalisation is carried out on subsequent closings to true-up all investors as if they had joined the fund on day one, in order to be able to share the benefits (the distributions) as if they were investors that had joined the fund at first closing.

Preconditions for equalisation

There are two preconditions for carrying out an equalisation process:

- 1.The first is to have a subsequent closing.
- 2.The second is to have drawdowns between closings.

If there are no drawdowns between the first and the subsequent closing(s), there is nothing to equalise, therefore no equalisation is required.

Equalisation payments by subsequent investors are usually required if commitments – whether loan commitments in UK funds or capital commitments in US or funds from other jurisdictions – have been drawn down between the first closing date and the relevant subsequent closing, but in some cases the equalisation could be the subsequent investor-closing date either stated in the LPA or for practical reasons if the first drawdown is delayed. Given that new investors are required to contribute as if they have joined the fund on day one, the calculated drawdown amounts are considered due on the original drawdown dates and equalisation interest is calculated between the date of the original drawdown and the subsequent investors' first drawdown date when they are required to pay the equalisation amounts.

What happens in an equalisation?

For the new investors, they will have to:

- contribute their share of investments made (if any) or a fixed percentage of the commitment;
- pay arrears of management fees;
- pay arrears of expenses;
- pay equalisation interest to the old investors for late arrival; and
- pay equalisation interest to the GP on management fees for late arrival.

For the existing investors, they will:

- receive funds from new investors to equalise; and
- receive equalisation interest to compensate them for funding the share of the new investors.

It is important to note that the money received from the new investors does not belong to the fund and it needs to be paid to the old investors (except for amounts in respect of management fees, which are

calculated on the additional increased commitment and are due to the GP), but what happens very often is that these amounts are netted off against the next drawdown.

Calculation of the equalisation amounts

There are four elements that make up the equalisation calculation:

- The first element is an equalisation amount in respect of investments (if any) and organisational expenses/establishment cost and fund/partnership expenses. This is an amount required to equalise (from old to new commitments) the net amount drawn down from investors, which is payable by the new investors to the old investors.
- The second element of the equalisation calculation is an equalisation amount in respect of management fees/priority profit share (PPS). This amount is calculated retroactively to the initial closing date on the additional commitments and it is payable by new investors to the GP.
- The third element of the equalisation calculation is the equalisation interest payable to the old investors – basically to make it fair and square to the old investors for funding the equalisation amount on behalf of the new investors. An additional amount, called equalisation interest is calculated as interest on the equalisation amount for the period from the relevant original drawdown date to the subsequent investor first drawdown date or to the relevant subsequent closing date as the LPA stipulates, payable by new investors to either old investors (for investments, organisational expenses/establishment cost and partnership/fund expenses). The equalisation interest rate is usually stipulated as a reference interest rate plus a margin (for example, London Interbank Offered Rate (LIBOR) plus 2 percent) or it might be equal to the hurdle rate (8 percent or otherwise). Equalisation interest is excluded from the commitment and similar to the equalisation amounts does not belong to the fund.
- The fourth element of the equalisation calculation is the equalisation interest on the management fee/PPS payable to the GP and that is why it is calculated separately. Similar to the equalisation interest due to the old investors, it is outside of the commitment and does not belong to the fund. The equalisation interest rate on the management fee may be different from the one on the equalisation amounts due to the old investors.

The equalisation calculation is relatively straightforward. A simple

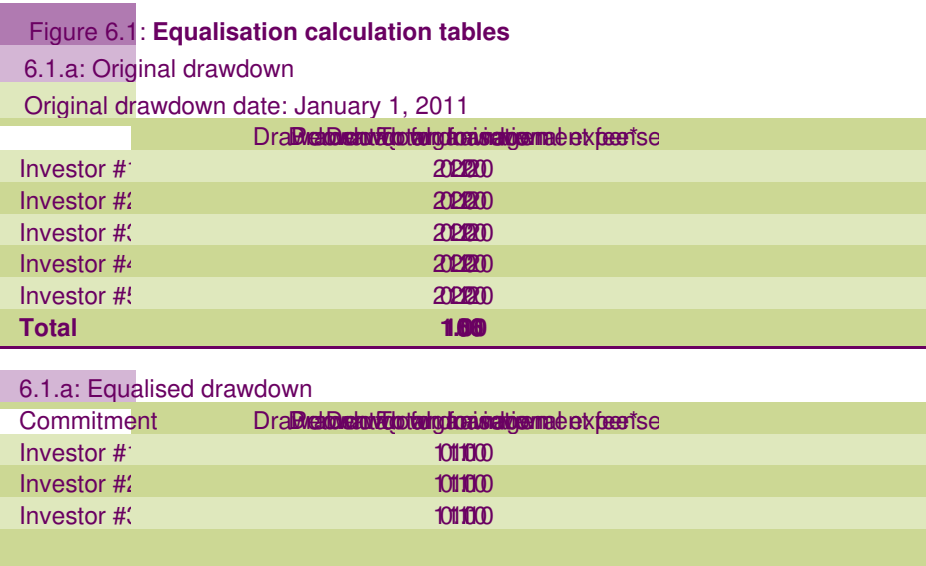
Microsoft Excel spreadsheet allows you to make the calculation by taking the original (actual) drawdown in one column, calculated for each investor in line with the original commitments, and then compare it to what it should have been if the subsequent investors had been investors on day one, in a second column – that is the equalised original drawdown.

The difference between the two columns is the equalisation amount. Of course you need to calculate each item separately, that is, amounts for investments, organisational expenses/establishment costs, fund expenses and management fees/PPS. Alternatively, as a minimum (although I would not recommend this as you will probably want to keep track of each item) split the amounts in respect of management fees/PPS, which are due to the GP from the other amounts due to the old investors.

In addition to that you also need to calculate the third and the fourth elements of the equalisation – the equalisation interest on each element of the original drawdowns for the period from the date of the original drawdown to the date of the subsequent investors' first drawdown, in which the equalisation is included (or the relevant subsequent closing date as the LPA stipulates).

It is important to make sure that the equalisation interest on the management fees/PPS is calculated separately as it needs to be paid to the GP and not the original investors.

Figure 6.1 over the page illustrates a simple example of equalisation calculation.



Investor #1	10100
Investor #2	10100
Investor #3	22200
Investor #4	33300
Total	111000

6.1.c: Equalisation drawdown

Equalisation drawdown date: March 31, 2011

						LIBOR [*] 2%	LCY ^{**} 12%	IBOR [*] 3.00%	Number of days	
	Commitment	Percentage of total commitment	Equalisation amount due to investor	Drawdown for organisational expenses	Equalisation amount due to investor after drawdown	Total equalisation amount	Equalisation amount due to investors	Equalisation amount due to GP	Total equalisation amount	Total equalisation drawdown
Investor #1	100	10.00%	(10)	(0.10)	-	(10.10)	(0.12)	0.00	(0.12)	(10.22)
Investor #2	100	10.00%	(10)	(0.10)	-	(10.10)	(0.12)	0.00	(0.12)	(10.22)
Investor #3	100	10.00%	(10)	(0.10)	-	(10.10)	(0.12)	0.00	(0.12)	(10.22)
Investor #4	100	10.00%	(10)	(0.10)	-	(10.10)	(0.12)	0.00	(0.12)	(10.22)
Investor #5	100	10.00%	(10)	(0.10)	-	(10.10)	(0.12)	0.00	(0.12)	(10.22)
Investor #6	200	20.00%	20	0.20	2	22.20	0.24	0.00	0.24	22.46
Investor #7	200	20.00%	20	0.20	2	22.20	0.24	0.00	0.24	22.46
Total	1,000	100.00%	-	0.00	5	5.00	0.00	0.06	0.06	5.06

* Assume that for the purposes of the equalisation calculation the management fee is calculated at 2% p.a. and is drawn from LPs and payable to GP semi-annually in advance

** Assume that for the purposes of this equalisation calculation the LIBOR equals 3%Initial, subsequent and final closings, rebalancing & equalisation

Accounting implications

- Equalisation amounts for both investments, organisational expenses/establishment costs and partnership/fund expenses, on one hand, and management fees/PPS, on the other hand, should be credited to the loan-contribution account (if a UK fund) or capital-contribution account (if a US or similar fund) contribution account of new investors.
- Amounts calculated for investments, organisational expenses/establishment costs and partnership expenses payable by new investors will be distributed to the original investors after receipt from new investors or netted off the next drawdown amounts if all done in one drawdown. They will be in partial repayment of the outstanding loan (if a UK fund) or capital (if a US or similar fund) contributions of the original investors and will increase their undrawn loan (if a UK fund) or capital (if a US or similar fund) commitments and thereby should be considered redrawable.

- Amounts calculated for of management fees/PPS payable by new investors will be paid to the GP.
- Equalisation interest will not be reflected in the capital or loan account of new investors and will not be treated as a distribution by old investors. The portion calculated for investments, organisational expenses/establishment costs and partnership/fund expenses is payable to the old investors and the portion calculated in respect of the management fee/PPS is due to the GP.

Sample journal entries (postings)

In terms of the journals entries that need to be posted, the following are sample journal entries to reflect the different elements of the equalisation process in your accounts:

Journal entry 1

Equalisation amount for investments, organisational expenses/establishment costs and partnership/fund expenses (but not management fees/PPS)

Journal entry 1.a: New investors (investors #6 and #7):

~~50.50~~ All receivable (investors #6 and #7)
~~50.50~~ an/capital contributions (investors #5 and #6)

In that journal, amounts should be allocated only to the new investors #1 (20.20) and #7 (30.30) as per the equalisation calculation in [Figure 6.1.c](#).

Journal entry 1.b: Original investors (investors #1, #2, #3, #4 and #5):

~~50.50~~ an/capital contributions (investors #1, #2, #3, #4 and #5)
~~50.50~~ All receivable or due to Investors (investors #1, #2, #3, #4 and #5)

If you will be drawing down other funds for investments, management fees/PPS and/or fund expenses with this drawdown for equalisation, then you can credit the call receivable account, but if you will be drawing only the equalisation amounts then you may want to use the due to investors (or similar) account. The total amount for that journal should be exactly the same as in Journal Entry 1.a. (see above), but allocated between the original investors #1, #2, #3, #4 and #5, instead of the new investors #6 and #7 in line with the equalisation calculation in [Figure 6.1.c](#).

What we are trying to achieve with these two journals is to reallocate loan (in a UK fund) or capital (in a US or similar fund) contributions from old investors to new investors (that is, to increase the new investors' loan/capital contributions and decrease the original investors' loan/capital contributions) and get the new investors to pay to the original investors, so that we can true up the drawdowns as if the new investors were investors on day one. We do not draw additional amounts from the new investors for the fund to keep – this money does not belong to the fund; the fund has already drawn down the amounts that it needed for investments, organisational expenses/establishment costs and fund expenses, so with these journals the amounts previously drawn down will be equalised to reflect the new commitment ratios.

In the cases where the drawdowns are calculated as fixed percentage of the commitment instead of being a specified amount, the fund will keep and use the funds later on and the drawdowns are not equalised.

Journal entry 2

Equalisation amount for management fees/PPS

Journal entry 2.a: True-up/catch-up management fees from the new investors (investors #6 and #7):

Dr Call receivable (investors #6 and #7)

Cr Loan/capital contributions (investors #6 and #7)

With the equalisation of the management fees/PPS, this does not return money to the old investors as was the case in Journal Entry 1 for the amounts for investments, organisational expenses/establishment costs and partnership/fund expenses. The reason to calculate the management fees/PPS on the additional commitments from the investors and therefore an additional amount of management fees/PPS is due to the GP which has not been previously drawn down and paid to the GP in line with [Figure 6.1.c](#).

Journal entry 2.b: Management fee/PPS due to GP:

The additional amount to draw down retroactively from the new investors for management fees/PPS is due to the GP and the following is one possible way of reflecting that, but you may have a different way of accounting for your management fees/PPS, therefore this journal needs to be consistent with your accounting method.

Dr Management fees (expense) (or GP drawings if PPS*)

*Accounting for PPS is more complex and this is just a simplified journal. More on the accounting for PPS in [Chapter 12](#).

Journal entry 3

Equalisation interest

Journal entry 3.a: Equalisation interest in respect of investments, organisational expenses/establishment costs and fund expenses (but not management fees/PPS):

This amount is due from new investors to old investors. One way of doing it is to use a suspense account as this amount will go in and out, or alternatively you can set up a separate new account or use an existing due-to-investors (or similar) account or simply put it through the call receivable account, allocated to the original investors (in the example investors #1, #2, #3, #4 and #5), whichever you feel is tidier for you and more consistent with your accounting policy and methodologies.

~~D.06~~ Call receivable (investors #6 and #7)

~~C.68~~ Suspense account or due to investors or simply call receivable (investors #1, #2, #3, #4 and #5)

Journal entry 3.b: Equalisation Interest in respect of management fees/PPS:

~~D.06~~ Call receivable (investors #6 and #7)

~~C.06~~ Suspense account or due to GP

Again, it is your choice whether to credit the suspense account if you want to channel your equalisation interest through that account or you want to use the due-to-GP account if you have posted the management fee/PPS due to the GP to that account, so that you know what the total amount is – additional management fee/PPS due from the new investors on equalisation plus the equalisation interest, due to the GP – whichever is neater and consistent with your accounting policy and methodologies.

Journal entry 4

Finally, receipts from new investors (investors #6 and #7) and settlement of original investors (investors #1, #2, #3, #4 and #5) and GP accounts:

Journal entry 4.a: New investors (investors #6 and #7):

~~50.00~~ Cash

~~50.00~~ Call receivable (investors #6 and #7)

Journal entry 4.b: Settlement of the original investors' (investors #1, #2, #3, #4 and #5) accounts:

If you are running another drawdown and the equalisation is put through that drawdown, the amount due to the original investors (in this example investors #1, #2, #3, #4 and #5) will simply be offset against the call receivable from the old investors from that drawdown or if you want to wait until the next drawdown and offset it against that next drawdown, then no more journals are required (except for clearing the suspense account if you have used one), but if you are not envisaging any drawdowns in the near future and only want to run a drawdown for the equalisation and if you want to settle these amounts, then the following journal is needed to reflect the cash settlement of the old investors receivable.

Dr Call receivable (investors #1, #2, #3, #4 and #5) (for 50.50 equalisation amount in respect of investments, organisational expenses/establishment costs and fund expenses)

Dr Suspense account/due to investors/call receivable (whichever you have used for the equalisation interest)

Cr Cash (to investors #1, #2, #3, #4 and #5) 51.10

Journal entry 4.c: Settlement of GP's receivable:

Dr Due to GP (for the amount in respect of the additional management fee due from the new investors #6 and #7 on equalisation)

Dr Suspense account or due to GP (whichever you have used for the equalisation interest)

Cr Cash

These are only sample journal postings. Of course you may modify them to suit your accounting practices or you may use a variation to make your accounting processes more efficient – it is entirely up to you, as long as you achieve the end result and allocate to each partner/investor – original and new – a fair share (as per the new commitments) of all the drawdowns carried out between the Initial and the subsequent closings or in other words, to equalise (in terms of contributions) all the partners as if they were partners on day one, as well as reflect appropriately all the other secondary transactions (for example, equalisation interest).

Rebalancing

As for the equalisation process, the process of rebalancing is carried out on subsequent closings to true-up all investors as if they have joined the fund on day one.

So, what is the difference between rebalancing and equalisation? Why do we need rebalancing? And what is to be rebalanced?

Before answering these questions it is useful to look at the preconditions for rebalancing.

Preconditions for rebalancing

What is different from the equalisation is that there is actually only one precondition (precondition number one below) for carrying out a rebalancing process. Technically speaking, there is a second one (precondition number two below), but since it is very unlikely not to have any transactions/journal postings in between the closings – if you have a closing, if no other transactions, but there would at least be a drawdown for the capital contributions, and most likely for loan/capital contributions as well. So to summarise the two preconditions:

1. There needs to be a subsequent closing.
2. There needs to be transactions/journal entries/postings, generally allocated on commitment basis, in between the closings (except for transactions/journals that do not require rebalancing).

The process of rebalancing is performed regardless of whether or not there have been any drawdowns.

As you already know, in partnership accounting you need to be able to allocate to each partner a share of the net asset value (NAV) of the fund, represented by the partnership's assets, liabilities, expenses, income and gains/losses depending on each partner's share in the partnership, that is, their commitments (provided that the allocation is done using the most common allocation rule – by commitment taking into account the closing dates; for more information on allocation rules refer to [Chapter 16](#)). When there are subsequent closings the partners' shares change from closing to closing – there are new commitments for the new investors and as a result of that the shares of the old investors are diluted – and if there are any transactions between the closings (although you will see that not all the transactions are to be rebalanced), some process is needed to rebalance each partner's share in those assets, liabilities, expenses, income and gains/losses,

which were arrived at as a result of the transactions/journal postings.

In essence, rebalancing needs to be done to allocate a fair (according to the new commitments) share of all assets, liabilities, expenses, income and gains/losses to each investor.

A very simplistic approach that some accountants take is to rebalance the balances on the accounts, but that will most likely not give an accurate result as some of the resultant transactions would not be allocated on a commitment basis; for example, receipts from drawdowns should be allocated to specific investors, not allocated on a commitment basis between all the investors or if there is an opt-out where your sharing percentages are distorted or some other transactions (for example, drawdowns for management fees) do not need to be rebalanced at all. Therefore, the more sensible, but very laborious (if performed manually) approach would be to rebalance transactions/journal postings instead of the balances that resulted from those transactions/journal postings. However, you should be prudent with that approach as not all the transactions should be rebalanced as mentioned above, although if there are no specific allocations or other complications rebalancing could be done at the general ledger (GL) account level.

In terms of processes, rebalancing is usually done as a separate (from equalisation) exercise. If you are using a specialist private equity accounting platform/software you probably have a separate, most likely automated, facility within your platform to perform that process as doing it manually might be a laborious process if performed on a transaction-by-transaction basis as recommended above. However sophisticated your software, you cannot rely on it to deliver fully accurate results, and not only for the reason that it does not use accurate algorithms, but rather for the reason that there might be something specific in your funds which has not been factored into the algorithm (for instance there may be unrealised/fair-value gains/losses or realised gains/losses that the GP might decide, or the LPA may state that are not to be allocated to new investors) or more likely a human error in your postings. Ideally, you should understand the algorithm that your software uses to perform different processes, but be prepared to make adjustments when it does not do exactly what you expect it to do.

My advice would be to always have some expectation, for example an Excel proof, and compare the result that your system generates to that expectation. Where there are differences, analyse them and try to figure out the reason for those differences in order to correct or justify

them. This assumes that your expectation is correct of course because sometimes you may need to change your expectation. In most cases though, in my experience, the differences would come from human error or poorly considered processes by the person completing the postings, particularly in terms of impact on potential rebalancing (for instance, rebalancing journals for drawdowns of management fees, which are not supposed to be rebalanced). Whatever the reasons and whether you need to change the result that your system generates or you need to change your expectation, at the end of the process they should essentially be aligned.

Summary

In this chapter I have discussed the first set of events in the lifecycle of a private equity fund which usually take place within the first 12 months of the fund's life – the initial/first closing of the fund, potentially followed by subsequent closings and ending with the final closing (usually taken place within a specified timeframe, for example 12 months of the initial closing). I have focused on the specific accounting processes stemming from these events, namely the equalisation and rebalancing processes that need to be carried out by the fund accountant(s) with a simple numerical example of an equalisation calculation and the relevant journal entries that need to be posted by the fund accountant.

These processes are very important and can sometimes be tricky in terms of calculation, so you need to understand the theory and reasons behind them and always take into consideration the specific provisions in your fund's LPA because they may be different from the general case described in this chapter. You may also need to understand how your accounting platform/software works (if a specialist private equity accounting platform is used) and always be critical of the result generated automatically by it and have in mind your own expectation about that result to allow for comparison.

Now that you have been introduced to the rebalancing and equalisation processes, in the next chapter I will introduce you to the next accounting process in the private equity fund lifecycle – the drawdown.

¹ For more implications on ERISA investors please refer to [Chapter 4](#).

² Please note the changes to the US Investment Advisers Act of 1940 (the Advisers Act) as a result of the Dodd-Frank Act and the new exemptions and check how these changes will impact your structure. At the time of writing this publication, the US SEC has postponed the registration probably until first quarter of 2012 from the originally

planned deadline for registration of July 21, 2011.

³ W-8 Form (for non-US investors) and W-9 (for US investors) are US tax (IRS) forms usually provided to investors as part of the subscription documents pack and are used when US source income is flowing outside the US, in order to ensure that the appropriate withholding is levied on the outflow of funds. If the investor does not provide W-8 or W-9 form to confirm what kind of an entity it is or what tax residency status is, the partnership would have to withhold from the investor at the maximum rate (30 percent as at the publication) rather than a lower or even a zero rate potentially applicable in accordance with the tax treaty benefits that the relevant investor is entitled to.

Drawdowns

By Mariya Stefanova

This chapter discusses:

- What is a drawdown or a capital call?
- Where are drawdown rules stipulated?
- Content of the drawdown notice
- ILPA Private Equity Principles Version 2.0 and standardised reporting templates
- What happens in terms of processes?
- Drawdown date
- Capital and loan contributions
- Recallable/redrawable amounts
- Drawdown calculation
- Net drawdowns
- Accounting implications and the impact on financial statements
- Treatment of partners' capital under IFRS – equity versus liability

The definition of a drawdown/capital call

A drawdown, which is also called a capital call or simply a call, is a process of drawing down or calling funds from investors¹ on an as-needed basis when an intended investment is to be made, the management fee is due (or soon will be due) to the general partner (GP) or partnership and/or organisational expenses have been or are to be incurred. Generally drawdowns are made out of the amount the investors have committed at the outset (within commitment), but on certain occasions for some funds certain drawdowns are made outside the commitment.²

Where are the drawdown rules stipulated?

All the rules governing drawdowns should be provided for in the limited partnership agreement (LPA) – including the drawdown calculation, allocation to partners, timing of the drawdowns, contents of drawdown notices and defaults.

Other documents related to a drawdown

In addition to the limited partnership agreement (LPA), which stipulates the rules of the drawdowns, another important document in which the drawdown materialises is the drawdown notice, also called a capital-call notice.

A drawdown notice is the formal letter served to investors with the aim to call the required funds. The drawdown notices are sent to the fund's investors in advance, allowing them enough time (usually 10,12 or any other number of business days stipulated in the LPA) to transfer the funds requested by the fund and contains details on the drawdown – the purpose of the drawdown, amount(s), breakdowns of those amounts by purpose (for example, for investment ABC, management fee for first quarter 2011, partnership expenses, etc.), drawdown date, any additional investment information (if for investment) or other details about the drawdown, as well as some additional (for example, cumulative contributions prior to and after the drawdown, percentage commitment called with the drawdown, etc.).

In simple terms, what happens in a drawdown is that a letter, called a drawdown notice is issued by the GP (or its third-party service provider) and sent out to the investors, which are expected to deliver the funds by a particular date, called the drawdown date.

Content of the drawdown notice

In terms of the content of a drawdown notice, which is usually stipulated in the LPA and a template provided as an appendix to the LPA, practice varies from fund to fund, but the drawdown notice will generally state: 'Dear investor A, please send X amount of money on Y date to the fund's bank account (bank details provided).'

Good drawdown notices are approximately three or four pages in length and are made up of the following:

- A cover letter (optional).
- The actual drawdown notice.
- Schedule to the drawdown notice.

- Acknowledgement of receipt of drawdown notice (optional).

Cover Letter

This is optional, but a personal address to the investors by a senior officer always shows that you value them and it is a personal relationship that you want to build with them after all (or even in the first place).

Actual drawdown notice

The actual drawdown notice usually contains the following requisites as a minimum:

- Reference to the LPA.
- Reference to the investor's commitment stipulated in the notice.
- Total amount of the drawdown.
- Portion of the call the investor.
- Purpose of the drawdown.
- Payment instructions (full bank details to which the funds are to be transferred).
- Due date by which the funds are expected to reach that bank account (drawdown date).
- Issue date of the drawdown notice.
- Any other information deemed appropriate by the GP.

Schedule to the drawdown notice

Although the following information may be part of the actual drawdown notice, it looks neater to keep it on a separate page in a more tabular format as a schedule to the drawdown notice:

- Fund size/total commitment (if not provided in the actual drawdown notice).
- Cumulative contributions prior to this drawdown (in absolute amounts and in percentage of the total commitment).
- Amount and percentage (of the total commitment) called with this drawdown.
- Remaining/outstanding/unfunded commitment prior to this drawdown (in absolute amounts and in percentage of the total commitment).
- Remaining/outstanding/unfunded commitment after this drawdown (in absolute amounts and in percentage of the total commitment).

- Other information as deemed useful by the GP and/or requested by LPs.

If you want to provide a more detailed breakdown of the drawdown and/or additional information on the portfolio company the money will be invested in, you could do that either in the main body of the drawdown notice or in that schedule.

Acknowledging receipt of drawdown

This is entirely optional, but as a good practice and to avoid last-minute surprises, one of the pages of the drawdown notice (usually the final page) could be an acknowledgement of the receipt of the notice by the investor, to be returned to the GP (or its administrator).

This can avoid situations in which investors may have not received the notice and therefore have not transferred the funds on the required date when the funds are needed, for say, an investment when fund Z has committed to the vendor to transfer the money on Y date. (A sample drawdown notice is provided in [Appendix II](#)).

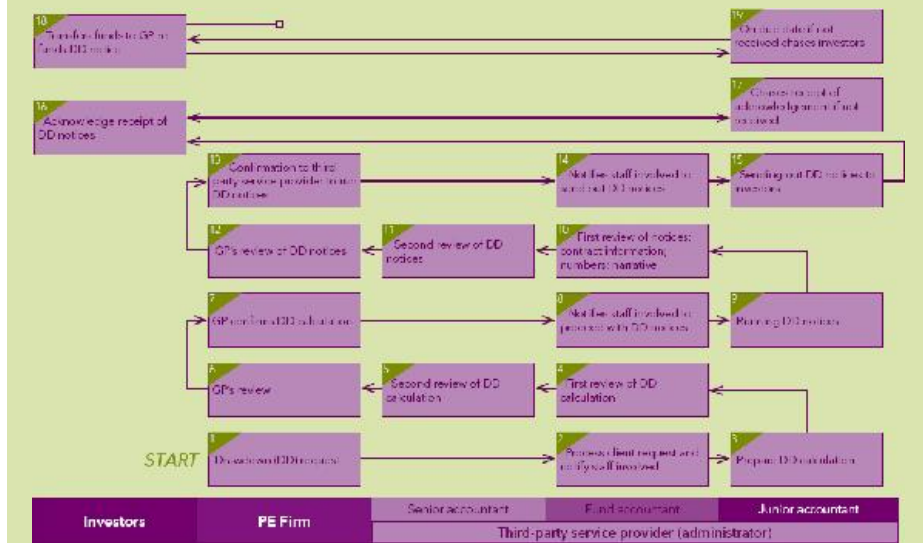
ILPA Private Equity Principles Version 2.0 and Standardised Reporting Templates

In January 2011, ILPA released its Private Equity Principles Version 2.0. Along with the Principles, ILPA has released the first two of a series of planned standardised templates – the Capital Call and Distribution templates. In late October 2011, ILPA released a proper Best Practice document for capital calls and distributions and the next of their series of standardised templates and Quarterly Reporting Standards Best Practices. These templates could be highly beneficial to the asset class; however, to what extent they will be adopted by GPs is not certain.

These standardised templates are very useful and I would strongly recommend that you check them and benchmark your capital call/drawdown and distribution notices and quarterly reports against them, as that is probably what your LPs would expect from you in the future.

Whether or not the GPs will follow suit and adopt the templates only time will tell, but I have recently seen providers of specialist private equity software platforms that are already implementing these formats as a recommended best practice.

Figure 7.1: Sample process map of drawdowns outsourced to third party service provider



What happens in terms of processes?

Your processes for drawdowns would depend on whether you produce them in-house (if you work for a private equity house) or you delegate them to a third-party service provider (for example, a fund administrator) who does it for you.

Outsourcing to a third-party service provider

If you outsource drawdowns to a third-party provider, generally all you need to do is first give your provider the heads-up about when and what you are planning to draw down, so that it can start doing some preparation work in advance of the drawdown (such as management fee calculation and carried interest if the fund is in carry). Closer to or on the date when you want your provider to effect the drawdown, you will confirm the amount and provide the final breakdown by item (for example, X amount for investment in project ABC, Y amount for management fee for quarter Z in year YYYY and XX amount for partnership expenses). You may also want to provide the exact wording of the description of these items, particularly if you are calling money for an investment and you want to include additional, more specific information on the potential portfolio company for the investors (for example, €50 million for project ABC Telecom, a European telecommunications market leader with 10 percent share of that

market). Then when the third-party service provider sends you the calculation and the drawdown notices, you review them³ – including the calculation, allocation to investors in line with the prescribed allocation rules in your LPA, as well as the content of the letters, including contact information and bank details, on an investor-by-investor basis or on a test basis. If the process is very simple and you do not have a team of fund accountants with the relevant hierarchy and different responsibilities, you may not need to have a formal procedure in place, but if you do, [Figure 7.1](#) provides you with a basic sample process map that you could use to help you develop your own process.

Private equity firms using internal resources

If you work for a private equity house and produce your drawdowns in-house, it would be good practice to have some kind of formal procedure, again particularly if you have a team of fund accountants with the relevant hierarchy and different responsibilities with regards to producing them. You can modify [Figure 7.1](#) to develop your own process.

Service providers producing drawdown notices for clients

Usually, third-party service providers have strict procedures in place for each process that they carry out for clients, where responsibilities are divided and the rule of ‘at least two pair of eyes’ for the review process applies. Similarly, you can modify [Figure 7.1](#) to develop your own process.

Drawdown date

Should the drawdown date be the date of the letter (the drawdown notice) or another date?

I have heard arguments and seen funds where the date of the letter is considered to be the date of the drawdown, but you need to ask yourself the question: what does really happens on that date to be really used as a date of the transaction? The answer is that nothing happens, except for issuing the letters. Although useful in defining when the funds are due to the partnership (for example, ten days from the issue day), that should not really be the date of the drawdown. The date of the drawdown should rather be the date when the funds are

due and therefore that should be the general ledger (GL) date of the journal posting and that same date should be the date used for the purposes of the IRR calculation.⁴

Capital contributions

As explained in more detail in [Chapter 2](#) and [Chapter 4](#), one of the distinctions between a UK and a US fund, due to some specifics in partnership law, is the treatment of capital contributions. In US funds the partners make only capital (equity) contributions, while in UK funds only a small proportion of the commitment – usually 0.001 percent or 0.01 percent of the total commitment – is in the form of capital contributions. This tiny equity proportion is drawn at the outset – on admission – with the first drawdown and that is why it is usually called the initial capital contribution. If the commitment is increased later on, the partner with the increased commitment makes a subsequent capital contribution to reflect that increased commitment.

GP and FP contributions as fund investors

Bear in mind that the GP (and for UK funds founder partner (FP) if you have one in your structure) may invest in the fund (for example, 1 percent of the total commitments) and therefore funds (both capital contributions and loan contributions) may be drawn down from them in their capacity as investors. That is usually done to reassure the LPs that the GP/FP has confidence in how the fund is managed, basically the GP/FP is investing in its own fund and that is a statement of confidence in its ability to manage the fund.

Bottom line, the GP and FP may have two different capacities – as investors or LPs in the fund (fund accountants usually refer to it as GP/FP as an LP) and as GP and FP of the fund (fund accountants usually refer to it as GP as GP and FP as FP), respectively, and therefore funds will be drawn down from them in two different capacities, that is, as LPs and GP/FP. You need to distinguish between these two very different capacities and in specialised private equity platforms they are set up as separate partners, although they are the same legal entities in real life.

Carried interest partner if set up as a separate entity

As explained in [Chapter 2](#), for UK structures with a carried interest partner (CIP) set up as a separate legal entity – usually an FP (or a

special limited partner (SLP)) – there are slightly different rules with regards to the capital contributions.

To support the premise that the CIP puts in capital and therefore later on will receive a return on its capital investment in the fund in the form of carried interest (as opposed to receiving a performance fee), the CIP is required to maintain such a proportion of the capital at all times (or sometimes that is to be checked only at the final closing) – for example, for a 20:80 carry proportion, the CIP is required to maintain 20 percent of the total capital contributions (not total commitment), and since that includes its own capital contribution, that is grossed up to 25 percent of the LPs' capital contributions. Very often, although this is basic mathematics, people I train ask me why, so I would prefer to prove the explanation now with a simple equation (not that it requires proving), but usually if they take the time to understand it at this point no questions are asked later on when carried interest and particularly catch-up are discussed where the same logic applies.

Explanatory equation:⁵

Where:

TCC = Total capital contributions

CC_{LPs} = LPs' capital contributions

CC_{FP} = FP capital contribution

$TCC = CC_{LPs} + CC_{FP}$

Here is the simple equation to prove my argument:

20% TCC = CC_{FP}

$20/100 (CC_{LPs} + CC_{FP}) = CC_{FP}$

$20/100 CC_{LPs} + 20/100 CC_{FP} = CC_{FP}$

$20/100 CC_{LPs} = 100/100 CC_{FP} - 20/100 CC_{FP}$

$20/100 CC_{LPs} = 80/100 CC_{FP}$

$CC_{FP} = 20/100 CC_{LPs} / 80/100$

$CC_{FP} = 0.25 CC_{LPs}$

Having explained this equation, the most important thing to remember is to check your LPA if these equalisations (that is, making sure that the FP has 20 percent of the total capital contributions) should take place at each closing or only at the final closing, but whatever the case might be, do not forget that you need to keep an eye on it and always make sure that the ratio is kept up-to-date. I have encountered situations in which fund accountants were not aware of that specific approach and therefore were not checking at each subsequent closing (as the LPA stipulated).

Likewise, the GP/FP forgot to make those additional capital contributions and they were left at the level of the first closing, and the accountants only realised that when they started building the carried interest model. In other situations, I have noticed it during the review process and raised the issue. So, make sure that you know your LPA inside out and remind the GP, if missed out, of those provisions and reflect them in the accounts.

Loan contributions

As explained in [Chapter 2](#), loan commitments and contributions are typical for UK-domiciled funds and they do not exist in US funds, due to the specifics of partnership law. This is the part of the commitment for each investor other than the 0.001 percent (or 0.01 percent whatever the case may be) capital contributions that equals 99.999 percent (or 99.99 percent where capital contributions are 0.01 percent of the commitment) of an investor's commitment. Loan commitments are advanced to the fund by the partners as required by the GP for different partnership purposes, including investments, management fees and partnership expenses.

In terms of accounting, capital contributions and loan commitments are kept in two separate GL accounts, very often, in a way, required by the LPA, which stipulates what different accounts (although it does not necessarily refer to GL accounts, but very often accounting just mirrors that structure) need to be kept, with the capital-contributions account being constant (relatively, at least after the final closing) over the life of the fund and the loan-commitments account fluctuating, reflecting the activities of the fund (for example, investing and divesting).

Redrawable/Recallable amounts

There is usually a clause in the LPA allowing the GP to make partners 're-advance' all or any part of the amount distributed to the extent that such a repayment is attributable to a loan repayment for temporary or bridge investments, establishment costs, ongoing expenses (fund expenses) and management fees – these are the so-called recallable or redrawable amounts.

Basically these amounts are subject to re-advance because a) for amounts drawn for expenses and management fees, these amounts have not been used productively, that is, invested and a return/profit on these amount generated and b) for bridge and temporary investments, these amounts have not been used to invest in a typical

way for the asset class, but are rather a quick flip.

Remember that in some funds these amounts are treated outside of the commitment and accordingly there is no need to re-advance at a later stage. Therefore, as a fund accountant you need to keep track of those amounts and reflect them where appropriate (for example, in the capital statements sent to investors quarterly).

Drawdown calculation

This includes calculation of each partner's share of the drawdown. When it comes to calculation, the LPA usually refers to calculation for each investor and in terms of allocation of the drawdowns between investors, most often, the total amount required to be drawn down is allocated proportionally (for each investor's commitment) between the investors (that is, 'by-commitment' allocation), but there are funds where allocation rules are much more complicated, so as usual, read your LPA very carefully to find out what these rules are. For example, you may have an allocation by capital commitment (for UK funds, which may result in a different by-commitment allocation) or by remaining commitment. In certain situations, for example, if you have excused investors/opt-outs, this may result in different allocation compared to by-commitment allocation) or you may need to use sharing percentages (for example, different for different investments). You may even have different allocation rules for different elements of the drawdown (for example, one rule for investments, another for follow-on investments and completely different for fund expenses and management fees).

Figure 7.2: Drawdown

Drawdown notices as of January 31, 2011 ¹									
Drawdown date: January 14, 2011 ²									
	Commitment	Percentage of total commitment	Current balance before this drawdown	Remaining commitment	Percentage based on remaining commitment	Drawdown for investment C	Drawdown for partnership expenses	Drawdown for management fees	Total drawdown
Investor #1	100	19.80%	20	80	18.43%	18.43	1.98	2.00	22.41
Investor #2	100	19.80%	20	80	18.43%	18.43	1.98	2.00	22.41
Investor #3 (Excused Investor ³)	100	19.80%	10	90	20.73%	20.73	1.98	2.00	24.71
Investor #4 (Excused Investor ⁴)	100	19.80%	0	100	23.06%	23.06	1.98	2.00	27.02
Investor #5	100	19.80%	20	80	18.43%	18.43	1.98	2.00	22.41
GPI as Investor	5	1.00%	1	4	0.94%	0.94	0.10	0.00	1.04
Total	505	100.00%	71	434	100.00%	100.00	10.00	10.00	120.00

* The drawdown date is ten business days from the date of the drawdown notice date.

** Investor #3 is an excused investor and does not wish to participate in alcohol and cigarettes deals.

** Investor #4 is an excused investor and does not wish to participate in alcohol, cigarettes and gambling deals.

Figure 7.2 shows a simple example of using different allocation rules for different elements of the drawdown. Allocation rules are explained in further detail in Chapter 16.

In terms of drawdowns from the GP and FP, in different funds, there are different rules around these participants. Therefore, once again you need to carefully check your LPA concerning those rules so that you can establish from the outset if you need to draw down funds from them and if so how to calculate those amounts. As explained earlier in this chapter, do not forget to distinguish between the different capacities of the GP and FP – as LPs/investors and as GP and FP, respectively.

Bear in mind that complications may arise with some LPAs; for example you may have ‘deemed loan commitments’ for the FP which may mean that a certain proportion (for example, 1 percent) of the investors’ (other than the FP itself in its capacity as an investor) loan/capital contributions will be deemed to have been done by the FP/GP. This is the proportion that will be paid by the investors and reallocated from them to the FP/GP and to make things even more complicated (but fair, although that has no relevance to this chapter) these loan/capital commitments might be funded by a reduction of the management fee. Please keep in mind that this is only one example of the complications you might encounter.

A sample drawdown calculation where different allocation rules applied to the different elements of the drawdowns is presented in Figure 7.2.

In the example cited in Figure 7.2, the drawdown notices are dated and sent out to investors on January 3, 2011 and the money is due in ten working days, which falls on January 14, 2011. There are two excused investors (investor #3 and investor #4) that do not wish to invest in certain deals (for example, alcohol, cigarettes and gambling). Previously, there have been two drawdowns for investments A and B – investment A, which is a winemaking company (£10 million), and investment B, which is an online betting company (another £10 million). Investor #3 has only contributed funds for investment B and investor #4 has not contributed any funds at all. As a result, the percentages based on remaining commitment are different from the

percentages based on commitment. In this drawdown £100 million is drawn to be invested in investment C, which is a food company (all the investors will contribute to deal C). In addition to the investment, £10 million is drawn for partnership expenses and 2 percent management fee (for the whole year) is drawn in advance. The LPA stipulates that funds drawn down for investments are allocated between investors based on remaining commitments (to allow excused investors to catch up with the other investors), partnership expenses are allocated on commitment basis and management fee is calculated as 2 percent a year of each investor's commitment, except for the GP as an investor. It does not make any sense to draw down a management fee from the GP as an investor to pay it to the GP as GP (that is, to itself). This example illustrates that different allocation rules could be applied to the different elements of one drawdown.

Net drawdowns

Sometimes distributions are netted off against drawdowns (or vice versa) and a net drawdown notice (or a net distribution notice depending on which amount is higher) is served to the investors. However, in the drawdown notice the amounts of the drawdown and the distribution need to be stated separately; in the fund accounts the drawdown and the distribution elements should not be offset. The drawdown and distribution amounts should be accounted for separately in the appropriate manner as described in this chapter and in [Chapter 13](#), respectively.

Accounting implications — the impact on financial statements

Accounting for drawdowns is relatively simple. There is generally nothing complicated or convoluted in terms of journal entries or the impact on the financial statements, but what I would recommend is that, as a minimum, you make sure that you keep track of the different types of drawdowns. The different types include drawdowns for investments, drawdowns for management fees and drawdowns for partnership expenses.

Later on you will need that information, if for nothing else, at least you would need to know the cumulative amount of the management fees and the partnership expenses, as explained above, if they are within the commitment, they are usually redrawable following the logic that this money drawn down from investors has not yet been put to work.

In terms of impact on the financial statements, a drawdown will have an impact on the balance sheet and the capital account/partners' account through the capital- and loan-contributions accounts,⁶ call receivable and subsequently cash. Following are some sample journals to reflect the impact of a drawdown:

Journal 1: Drawing down funds (drawdown number one) amounts to £10 million for investment ABC Telecoms, £500,000 for the management fee for the first period (quarter) of entitlement and since this is the first drawdown, capital contributions of £1,000. It would also no doubt be sensible to expect that funds for establishment costs, such as an amount of £300,000, would be drawn down:

Dr Call receivable	10,801,000
Cr Capital contributions	1,000
Loan contributions	10,800,000

As explained above, it would be a good idea for the journal to provide for an extra analysis level of the loan-contributions account to reflect the different types of drawdowns depending on the purpose that the funds will be used for (including call for investments, management fees/PPS and partnership expenses). An additional analysis level, by investor, should be provided for the call-receivable account.

The impact on the balance sheet

Balance sheet (before Journal 1)

Investments	-
Call receivable	-
Cash	-
	-
Capital-contributions account	-
Loan-contributions account	-
	-

Balance sheet (after Journal 1)

Investments	-
Call receivable	10,801,000
Cash	-
	10,801,000
Capital-contributions account	1,000
Loan-contributions account	10,801,000
	10,801,000

The impact on the balance sheet

Journal 2: Receipt of funds from Drawdown 1.⁷

Dr Cash	10,801,000
Cr Call receivable	10,801,000

Balance sheet (before Journal 2)

Investments	-
Call receivable	10,801,000
Cash	-
	10,801,000
Capital-contributions account	1,000
Loan-contributions account	10,800,000
	10,801,000

Balance sheet (after Journal 2)

Investments	-
Call receivable	-
Cash	10,801,000
	10,801,000
Capital-contributions account	1,000
Loan-contributions account	10,800,000
	10,801,000

Journal 3a, 3b and 3c: Using the receipts from Drawdown 1.

Journal 3a. Making an investment in portfolio company ABC Telecoms amounting to £10 million.

Dr Investments	10,000,000
Cr Cash	10,000,000

Journal 3b. Paying the GP quarterly (in advance) management fees.

Dr Management fees (expense)	500,000
Cr Cash	500,000

Journal 3c. Paying suppliers for establishment costs.⁸

Dr Establishment costs	300,000
Cr Cash	300,000

The impact on the balance sheet

Balance sheet (before Journal 3)

Investments	-
-------------	---

Call receivable	-
Cash	10,801,000
	10,801,000
Capital-contributions account	1,000
Loan-contributions account	10,800,000
Income account	-
	10,801,000

Balance sheet (after Journal 3)

Investments	10,000,000
Call receivable	-
Cash	1,000
	10,001,000
Capital-contributions account	1,000
Loan-contributions account	10,800,000
Income account	(800,000)
	10,001,000

Treatment of partners' capital under IFRS

With regards to the classification of the contributions or in other words the partners' capital (understand both capital and loan contributions), do we treat them as equity or as a financial liability under IFRS?

As explained in this and other chapters, in a typical UK limited partnership there are two types of capital – capital contributions and loan contributions. All partners make a capital contribution. The limited partners provide loan capital – used to fund the investments, expenses and management fees – which is in essence structured as a subordinate loan, since this allows for the simplest legal processes in terms of drawdowns and distributions. The following section looks at the two different elements of the fund's capital separately, in terms of how they should be treated under IFRS that is as equity or as a financial liability.

Capital contributions

Could a capital contribution be regarded as equity? Or having a finite life due to be repaid at the end of that life, should it be regarded as a liability?

The capital contributions' main characteristic is that they entitle the holder to participate in sharing the profits and net assets of the

partnership on wind-up, which is broadly predetermined by the LPA. If the capital contributions are treated as a financial liability and they are repayable on winding up the fund, would that be enough to treat them under IAS 32 (and FRS 25) as a financial liability? Of course, there could be an argument that based on that characteristic, the capital contributions should be treated as equity, but according to the standards it is a relatively safe bet to treat them as equity instruments, which are redeemable at the end of the expected life of the fund, rather as equity.

This factor alone (that they are redeemable at the end of the life of the fund) would be insufficient to argue that the instrument is a liability and that is why most experts generally regard capital contributions as equity capital and not a financial liability.

Loan contributions

On the other hand it is more difficult to prove that loan contributions are equity – the following argument explains why. In a typical UK private equity limited partnership, the loan/capital commitments from the limited partners have the following characteristics:

- They are drawn down by the GP on demand and are redeemable when the GP deems it appropriate.
- There is no repayment schedule.
- They are only repayable to the extent that funds are available to make the repayment and the amounts that have not been redeemed are subject to write-off.
- They bear no interest.
- They are unsecured.
- They rank below any external creditors.

By examining all of the above characteristics, it could be concluded that the loan contributions have few characteristics or risks associated with a loan and should rather be classified as equity. I would state that there is a strong argument for this case and you should argue with the auditors if the case arises. However, although loan contributions are subordinated, they do not entitle the holder to participate in the residual net assets of the partnership and they rank higher than the capital contributions. Therefore, if you are claiming that the fund financial statements are full IFRS (UK GAAP) you should either show them as a liability or, if you firmly believe that they are rather an equity instrument, depart from the standards in that part. If you are reporting under the flexible investor-defined accounting framework (LPA GAAP),

then you can present them in the equity part of the balance sheet.

Summary

In this chapter, I have discussed the nature of drawdowns, the drawdown rules and the processes associated with them, comprising: the drawdown calculation and the various allocation rules that may be applicable; the contents of the drawdown notices (including the new ILPA guidance and templates); the timing of the drawdowns; the accounting treatment and impact on the financial statements; and the treatment of capital and loan contributions under IFRS and UK GAAP.

Although it would probably be logical for the next chapter to focus on distributions, as drawdowns and distribution are usually considered together, but given that distributions usually take place a later in the fund lifecycle they will be examined later on in [Chapter 13](#). The next chapter focuses on partner transfers, which may sometimes be confusing for fund accountants and can be messy if the underlying theory is not clear.

¹ In other words from limited partners, but for some funds also from the general partner and/or carried interest partner if set up as a separate legal entity (see [Chapter 2](#)).

² For example, some funds, instead of redrawing the amounts already drawn for expenses and management fees treat them outside the commitment.

³ That could be done either as one step or as two separate steps (I personally prefer the two-step process as it saves work if the calculation needs to be changed) – first the calculation and if the calculation is correct then give a green light to the third-party provider to produce the letters and then review the letters (or a sample of them).

⁴ The date of the drawdown (that is, the date when the funds are due) should rather be used for the purposes of the IRR calculation instead of the date of the actual cash flows when the funds hit the bank account, although some funds would prefer to use the date of the actual cash flow, but that would result in slightly different IRRs for different investors.

⁵ Ignore any GP contributions.

⁶ If you are new to private equity fund accounting and the format of the financial statements, you may want to consider reading [Chapter 15](#) first.

⁷ This journal is a cumulative one reflecting drawdown receipts from all the investors. In a real-life situation, there would be a number of journals for the receipts from each investor, many of them probably occurring on different dates.

⁸ Similar to note 7, for simplicity, I am assuming only one journal for payment to suppliers with regards to establishment costs.

08

Partner transfers

By Mariya Stefanova

This chapter discusses:

- What is a partner transfer?
- Vital documents for fund accountants to record transactions properly
- Accounting implications and the impact on financial statements
- Partner transfers in specialist private equity accounting systems
- Some complications and possible reasons

What is a partner transfer?

Following on from the discussion in **Chapter 6** about the implications of admitting new investors to the fund at subsequent closings, this chapter will outline the implications of transferring interests in the partnership with or without admitting new investors – substitute investors – to the fund at any one time, before or after the final closing.

The partner transfer is a transaction between two parties:¹

- 1.A transferor (or assignor) – an existing partner in the partnership that transfers part or the whole of its interest in the partnership to the second party.
- 2.The transferee(s) (or assignee(s)) – one or more existing partner(s) in the partnership or an external new substitute investor(s).

The partner transfer is conducted by way of sale, exchange, assignment, pledge or any other disposition, typically with the prior written consent of the general partner (GP). It is subject to certain conditions, but the GP will usually waive, in its sole discretion, any or all of those conditions and in many cases the other limited partners

(LP) have pre-emptive rights.

The following are some but far from all of the cases in which an LP may transfer all or any part of its interest, including any interest in the capital or profits of the fund and the right to receive distributions from the fund:

- If an LP defaults or envisages defaulting on its commitment, the GP may, usually in its sole discretion, offer the interest of that defaulting/potentially defaulting partner to the existing partners or admit to the partnership a substitute partner(s) to assume the whole or a portion of the defaulting partner's commitment.
- If the GP determines that there is a reasonable likelihood of a certain LP's participation in the fund having a material adverse effect on the GP, the fund, any portfolio company or any of their respective affiliates, the LP will try to dispose of its interest – in part or in whole – in the fund.
- When, to accommodate certain legal, tax, regulatory or other considerations of certain investors, interests in the partnership are cancelled to be given equivalent interests in parallel funds that have substantially the same terms as the main fund.
- For ERISA partners or public-plan partners, if a statute or regulation regarding the definition of plan assets changes or if the fund fails to qualify as a venture capital operating company (VCOC) or to satisfy the 25 percent exception in the case of ERISA partners or statute or regulation changes that make the investment illegal for public-plan partners.
- Other cases when the GP deems the transfer is in the best interest of the partnership, GP (and/or other related entities) and/or LPs.

Vital documents to record transactions properly

By now you will no doubt have figured out that the first thing that a fund accountant always needs to do is to identify the provisions in the limited partnership agreement (LPA). Partner transfers are no exception, so in this case you need to identify the provisions that deal with them. The LPA sets out all the rules for the transfer, such as conditions to transfer, restrictions, pre-emptive rights (if any) and other terms. The section of the LPA that deals with partner transfers may differ between LPAs: 'transfers' – completely dedicated to partner transfers; part of a larger section that deals with transfers and subsequent closings called 'transfers that focus on subsequent closing partners'; 'transfer or assignment of interests or shares'; or 'assignment of interest or shares and resignation from the partnership'.

The second task is to make sure that all other required documents are available. When you have them read them carefully you will be able to identify the information required for the accounting processes that will be run to reflect the partner transfer.

Transfer agreement/deed of transfer/deed of assignment

Whatever its name, this document sets out the agreement between the transferor and the transferee, for the transferor to transfer part or its entire interest in the partnership to the transferee. This document grants rights to the transferee with regards to the partnership interest being transferred and contains almost all of the information about the partner-transfer transactions – names of the transferor/assignor and the transferee(s)/assignee(s), amount and/or percentage of the partnership interest to be transferred and the effective date of transfer.

GP's consent to assignment of an interest

As discussed previously, the partner transfer typically requires the GP's prior written consent; the GP's consent to assign an interest is the written document endorsing the execution of the transfer. The document is addressed to the transferor/assignor and also confirms the details of the transaction.

Minutes of the governing body of the GP

Again, in respect of the GP's prior written consent, the minutes of the governing body of the GP is evidence that they have discussed and agreed the partner transfer in line with the provisions of the LPA. Details of the transaction will again be provided in this document, as well as a list of all the documents produced at the meeting, providing a check list for the documents supporting the transaction, in case of any concerns that some document is missing.

Other documents specific to certain jurisdictions

Form LP6 is a form filed with Companies House in the UK to officially notify a change to the partnership details, including new partners or changes to existing partners and, for example, a change in partners' capital contributions.

Most jurisdictions have some kind of official journal or newspaper where certain statutory notices are required to be published including; for example, notice of liquidation of a company or change of name. The transfer of interest in the partnership will most likely be considered an important change and therefore have to be officially announced in a journal or gazette. In the UK, for instance, under the Limited Partnership Act, a transfer of interest in an English limited partnership must be advertised in the London Gazette or in the Edinburgh Gazette for Scottish limited partnerships.

Filing Form LP6 and arranging a Gazette notice are often arranged by lawyers.

Accounting implications

Having explained the general workings of the partner transfer, the following section will explore the accounting implications, specifically the partner transfer's impact on the accounts and at what level the change will take place.

Firstly, to consider the level at which the change will take place, taking into account the nature of the transaction and the explanation above, the changes resulting from the partner transfer will take place at the investor level. The impact on the accounts at the high level will be zero, but at the investor level there are a few changes that will take place and some items that will remain the same.

Transfer of commitment

The first impact would be that the transferor transfers a fund commitment to the transferee(s) on a given transfer date. Since the commitment is a legal obligation for the investors to deliver cash to the fund as and when needed, the information is kept outside of the accounting, in the sense that there will not be any journal to reflect the transaction and therefore there will not be any impact on the trial balance. This does not mean that if you have a specialist accounting platform that allocates the transactions at the investor level you will not reflect the information somewhere in your system. In fact, the exact opposite is the case as reflecting the transfer of commitment is extremely important given that it will probably drive the whole process.

For example, in some systems you would be required to reflect the commitment to be transferred (as a percentage or as an absolute amount), the transferor and the transferee(s), and the date of the

transfer and the system will work out the rest for you. But do not be fooled by that simple explanation: it usually is much more complicated and things can go wrong, so you always need to have a clear expectation of the partner transfer outcome to be able to compare it with the actual system outcome.

The impact on the balance sheet – transfer of assets and liabilities

As explained in previous chapters, each partner holds an interest in the partnership's assets, liabilities, net income and gain/losses. The impact of the partner transfer's transaction on the balance sheet is that the interest in the fund assets and liabilities at the transfer date, previously owned by the transferor, is now held by the transferee(s) with effect from that date. Therefore, there should be a transfer of assets and liabilities (accounted for in the top part of the balance sheet) on a given transfer date.

Impact on the profit & loss statement – no transfer of historic statement

As each partner holds interest in the partnership's assets, liabilities, net income and gains/losses, the impact of the partner transfer transaction on the profit & loss statement (or actually the lack of it), is that the historic income, expenses and gains/losses amounts are not transferred from the transferor to the transferee(s). The profit & loss statement for both parties before and after the process should be unchanged. The profit & loss accounts allocated to the existing investor for the period up to the partner transfer date explain how its personal assets and liabilities achieved the balances that they had reached immediately before the transfer.

The fact that it has now decided to transfer its cash and investments to another party does not change the historic fact that it had earned certain income or had been allocated certain expenses while a participant in the partnership and, therefore, we would not expect that historic profit & loss to be transferred from the transferor to the transferee(s).

Figure 8.1: Impact of the partner-transfer transaction on the balance sheet

Balance sheet	Transferor before	Transferor after	Transferee before	Transferee after	Transferor at year-end	Transferee at year-end
Assets & liabilities						
Investments	100	-	-	100	-	150
Cash	11	-	-	11	-	21
Liabilities	(6)	-	-	(6)	-	(6)
Total net assets	105	-	-	105	-	165
Partners' accounts						
Capital contributions	1	1	-	-	1	-
Loan contributions	100	100	-	-	100	50
Net income & gains account	4	4	-	-	4	10
Partner transfer in/out account	-	(105)	-	105	(105)	105
Total partners' accounts	105	-	-	105	-	165

Source: Author's calculations

Impact on the balance sheet – capital accounts

The sum of all the transferor's capital accounts – the capital-contributions account, the loan-contributions (for UK funds) account and the retained-earnings accounts – which remain with the transferor, will be offset by a new partner-transfer capital account. The total capital accounts will net to zero and the equivalent, although in the opposite direction, will show in the partner-transfer account for the transferee(s).

Example - transfer impact

The example illustrated in [Figures 8.1](#) and [8.2](#) shows the impact of the transfer on the primary statements – balance sheet and income statement – explained above.

On January 1, 2011, one investor (the transferor) in a fund called ABC Capital LP transfers 100 percent of its interest in the fund to a substitute investor (the transferee) to replace it on July 1, 2011. Before the transfer, the profit & loss and balance sheet are in line with the first columns in [Figures 8.1](#) and [8.2](#), and are all attributable to the transferor as it is the only investor in the fund (for simplicity of this example).

After the partner-transfer takes place, before the year-end, there was a further drawdown of £50 million to fund an investment of the same amount and a further £10 million of investment income in the form of a dividend.

Figure 8.2: Impact of the partner transfer transaction on the profit & loss/ income statement

Income statement	Transferor before	Transferor after	Transferee before	Transferee after	Transferor at year-end	Transferee at year-end
Income	-	-	-	-	-	-
Investment income	10	10	-	-	10	10
Total income:	10	10	-	-	10	10
Partners' accounts						
Expenses	-	-	-	-	-	-
Fund expenses	(6)	(6)	-	-	(6)	-
Total expenses:	(6)	(6)	-	-	(6)	-
Net income:	4	4	-	-	4	10

Source: Author's calculations

Partner transfers in specialist private equity accounting systems

There are specialist private equity accounting systems that feature in-built automated facilities to assist with the partner-transfer process, which considerably help fund accountants. However, as briefly mentioned above, it is important for you not to rely completely on any system to do the partner transfer for you, no matter how sophisticated the system may seem. This does not mean that you should not be using the automated facilities in your accounting platform, but just that you should be careful to doublecheck any results. Although some specialised systems are quite good, do not leave it to a system to decide what the end-result should be; have an exact expectation as to what your investor-by-investor (for the partners involved) trial balance should look like and compare this with the result achieved by the system. It is surprising how often these two are out of line and it is the fund accountant's job to make sure that they are aligned.

Method 1 illustrates a suggested process about how to achieve that, but before proceeding with your partner transfer, I would recommend

that you make sure that all transactions up to the partner transfer date have been posted and are correct. If you want to change any transactions dated before the partner transfer, provided that your system allows for changing journals, after you have executed it, things will get messy and the original transfer will most likely no longer be valid.

Method 1 provides a suggested step-by-step approach for running an automated partner transfer process on a specialist private equity platform:

1. Before running an automated partner-transfer process, download a trial balance, from inception to the transfer date (inclusive), for all the partners involved – transferor and transferee(s) as of the partner transfer effective date.
2. Project the balances on each GL account for each partner involved with the partner transfer, based on the theory and example provided above; for example, no assets and liabilities left for the transferor after the partner transfer and no changes to profit & loss historical movements.
3. Run the automated process.
4. Now that the partner-transfer process has been completed, reconcile the results from the partner transfer to make sure that the new allocations are correct. You can do this by comparing the result generated by your system – the new investor-by-investor trial balance for the investors involved (transferor and transferee(s)) after the partner-transfer process – to your base expectation – the projected trial balance from Step 2. Make sure that you have checked the following points a) to e), but also keep the specifics of your system, and the precise method that you have adopted in your firm, in mind, as you and/or the system may do things slightly differently:
 - a. Have all the assets and liabilities account balances been transferred from the transferor to the transferee(s)?
 - b. Are capital accounts, such as capital contributions and loan contributions, unchanged?
 - c. Are profit & loss balances unchanged?
 - d. Does the movement in the partner-transfer account for each investor involved equal the net assets transferred, that is, either the total change in all assets and liabilities or the total change in capital accounts? This should be the same number.
 - e. Also check the commitments that would not show on your trial balance. These are probably recorded somewhere in a separate area of your system, possibly outside of your main accounting area.

If your new balances are out of line, provided that your base expectations are correct, start looking for the possible reasons leading to these differences. In some cases they may be justified, but you will find out that for most of them something has gone wrong, which is usually user-related. In some specific fund circumstances you may need to do a manual reallocation, as no one system can capture the variety of fund-specific circumstances.

Some complications and possible reasons

The logic of the system being used probably requires checks of all the journals posted against the transferor up to the transfer date only and the balances at that date would be adjusted. Therefore, any journals posted into your system before the partner-transfer process was run, with a date after the partner-transfer date, will stay untouched by the process, potentially meaning that they will still be allocated in line with the former – before the partner-transfer date – fund ownership. It is important to make sure that this is not the case.

The opposite situation – a journal dated before the transfer date but posted (or modified, provided that your system allows modification) after the partner-transfer process has been run – may also present a problem. If this changes the transactions allocated to the transferor, and you have not changed or rerun the partner-transfer process itself – you will have a problem and probably will need to rerun the process.

More complicated partner transfers with multiple transferee(s): these may be more difficult in terms of reconciliation, as the ledger balances are not clean.

Multiple transfers on the same date

Most systems can handle transactions with one transferor and many transferees, but cannot handle very well, if at all, transfers with one transferee and multiple transferors or someone transferring in and out on the same day. In these circumstances, manual intervention may be required to make sure there are no system-generated errors.

Transfer(s) and rebalancing in the same period

In some systems, when you have a subsequent closing with rebalancing and a partner transfer in the same period, the system cannot see the partner transfer on rebalancing and again that may

require additional manual intervention to make sure there are no system-generated errors.

Transactions on the transfer date

Transactions occurring on the transfer date may pose another challenge, and again, additional intervention may be required to resolve any issues; for example you may post the transaction with an earlier date (such as the day before) if the precise date is not crucially important.

In conclusion, your system may be intelligent and you may not face any of these problems or you may have a completely different set of challenges, but it is vital that you should know in detail the specifics of the algorithm that your accounting system uses. This allows you to anticipate the possible reasons for complications and to identify and fix them without learning by trial and error. The difficulty with relying on trial and error is that sometimes the implications are only realised a few years down the line after you have started using the system and it will be introduce considerable problems or can be costly (or both) to fix them. Therefore, make sure that you spend some time with the system, experimenting even with more complicated scenarios before you launch it, particularly if you have not been trained thoroughly by the system providers. Alternatively, employ someone who knows the system – whether on a temporary or permanent basis or as a third-party consultant – and even then be vigilant, as no system can provide for all the specifics of every fund. In any case, whichever system you use, always check the balances of all the parties involved in the partner transfer thoroughly.

Summary

In this chapter I have discussed the process of partner transfers and have explained the nature of the process, the parties and documents involved, the accounting implications and the impact on the financial statements at the investors' level. I have also addressed how a typical specialist private equity accounting platform would generally handle the process, illustrating some of the pitfalls and common mistakes/complications as well as the possible causes. The chapter also examines a suggested method for running an automated partner-transfer process on a specialist private equity platform to make sure that the outcome suggested by that platform is accurate.

Now that we have discussed a few very specific processes to private

equity – closings, drawdowns, equalisations, rebalancing and partner transfers, the next chapter focuses on investments, which is very important subject as that is the essence of the fund activities and can greatly impact your balance sheet. In fact, this is the biggest driver of your fund's net asset value, so it is very important to make sure you get it right.

¹ Regardless of the fact that there may be multiple transferee transactions, the second party – the transferee – is sometimes referred to in this chapter as if it is a single party.

09

Investments

By Mariya Stefanova

This chapter discusses:

- Why accounting for investments is so important
- Where we stand under IFRS with regards to IFRS 9 and IAS 39
- IFRS 9 – why change, how is it different from IAS 39 and when?
- Basis of measurement for investments – historical cost versus fair value
- What is a fair value?
- What a revaluation is and why we need to revalue investments
- Classification and accounting for investments and investment revaluations under IFRS – IAS 39
- Convergence between IFRS and US GAAP
- IFRS 13 Fair Value Measurement and FASB ASC 820 Fair Value Measurement
- Consolidation exemption – US GAAP and IFSB's Exposure Draft ED/2011/4 Investment Entities – a brief overview in the context of fair value of investments
- Accounting for and presentation of investments and investment revaluations under various GAAPs (IFRS, UK GAAP and US GAAP)

Introduction

Accounting for investments and investment revaluations is one of the most important areas of private equity accounting. Investments are usually the assets (or the balance sheet item) with the highest relative share on a private equity fund's balance sheet, whereas the other items represent miniscule shares (apart from at certain times). Even the cash balances for a typical private equity fund are comparatively lower in value, largely because private equity funds tend to immediately distribute all (or almost all) of their available cash back to

investors so that they can boost their internal rates of return (IRR). This means that the overall investment value would largely determine the fund's net asset value (NAV), which is so important to investors and would be part of very important calculations such as IRRs and carried interest.

At certain points in a fund lifecycle, with certain exceptions and for certain funds – particularly at the early stages when there are few investments and towards the end of the fund's lifecycle when there are very few remaining unrealised left – determining the value of investments and accounting for them is extremely important for the overall results. This is the reason why auditors usually scrutinise this area of the fund's accounting.

IFRS – where do we stand?

First and foremost I would like to clarify where we stand on the application of *IAS 39 Financial Instruments: Recognition and Measurement* and its replacement standard IFRS 9, also called *Financial Instruments*, which was issued in November 2009. It can be very confusing which version of IAS 39 you should use if you have not opted for a voluntary early application of IFRS 9. For example, in eIFRS (an online subscription service of the IFRS Foundation), there is a number of versions of IAS 39 (at the time of writing the chapter in late 2011) to choose from, so figuring out which one you should be using may be confusing. An explanation follows.

By way of background, previously (although still effective for entities that do not voluntarily adopt an early application of the new standard) *IAS 39 Financial Instruments: Recognition and Measurement* set out the requirements for recognising and measuring financial assets. However, many users and other constituents took the view that IAS 39 requirements were difficult to understand, apply and interpret. So, they urged the International Accounting Standards Board (IASB) to develop a new less complex and principles-based standard. Since 2005, IASB and the US Financial Accounting Standards Board (FASB) have been working towards improving and simplifying the reporting for financial instruments as a long-term objective. In April 2009, in response to the financial crisis and under the pressure from international bodies, such as the Financial Stability Board and the G20 leaders, IASB announced an accelerated timetable to replace IAS 39 and a new financial instruments standard IFRS 9 Financial Instruments was issued. In October 2010, IASB issued an expanded and amended version of the standard.¹

IASB's intention is to ultimately replace *IAS 39 Financial Instruments* entirely with IFRS 9 as the completely new standard. IASB's approach, however, in trying to respond quickly to the pressure, has been to implement the new standard in phases. As IASB completes each phase it deletes the relevant part of IAS 39 and creates chapters in IFRS 9 that replace the requirements in IAS 39.² Without wishing to criticise IASB's approach, there had to be a compromise and the most important argument (responding quickly to the financial crisis and the needs of IAS 39 users) prevailed. Having deleted some parts of IAS 39 has resulted in a number of versions of IAS 39, which could be very confusing for a less informed fund accountant unaware of IASB's stepped approach.

In terms of which version of IAS 39 you should be using, it is important to be aware that different providers of similar (to IFRS Foundation's eIFRS) services have different approaches. If you are using eIFRS as the ultimate source, keep in mind that you should reference the so-called Blue Book or 'IFRS Consolidated without early application version' for the relevant year. Whichever version you use, the bottom-line is that unless you are voluntarily adopting IFRS 9 earlier than the mandatory effective date (see below for discussion), the old classification of financial instruments, particularly financial assets since this chapter is about fund investments, is still valid. Therefore, if you have treated your investments as available-for-sale financial assets, you could still record them as such in your financial statements until the new IFRS 9 is effective.

Do not panic if you open a version of IAS 39 and you do not find certain paragraphs (paragraphs 10 to 58, plus many of the definitions with regards to the old classification in paragraph 9 in the 2011 version of eIFRS or equivalent in other similar products), the old classification is still there for you to apply, just check if you are using the right version of the standard.

Mandatory effective date of IFRS 9

Originally the effective date for IFRS 9 (still the case as at the time of writing of this chapter) mandatory application is January 1, 2013, with an early application permitted, as discussed. However, in August 2011, IASB issued an Exposure Draft (ED) No. ED/2011/3 *Mandatory Effective Date of IFRS 9*, which had a consultation period until October 21, 2011. This exposure draft proposed a new mandatory effective date for IFRS 9 as January 1, 2015 or entities are required to apply IFRS 9 for annual periods beginning on or after January 1, 2015. If this

later proposed effective date becomes reality, an announcement is likely in November 2011.

The suggested change in the mandatory effective date, considering constituents' views and IASB's intention, stated in the Basis for Conclusions of IFRS 9, has been to allow entities to apply the guidance from all phases of the project to replace IAS 39 at the same time.³ This would be a sensible approach if you are trying to make a decision on whether or not to apply it earlier. Generally, I would say wait until the mandatory date, so that you have more clarity on how to apply the new standard as a whole and not just implement it piecemeal as IASB goes through the different phases and approves the separate parts in the staged approach.

Considering the discussion above, this chapter will focus on the present treatment of IAS 39, as you would have probably three years (provided that the response to ED/2011/3 is positive and the new effective date turns into reality) to still apply IAS 39. For those of you who have chosen or will be choosing an early application of IFRS 9, I will discuss that in brief at the end of the chapter.

Basis of measurement for investments

In general accounting theory, there are basically two different measurement bases for assets and liabilities, and in light of the subject discussed, investments in particular. There are two measurement bases:

- Historical cost (HC).
- Fair value (FV).

Historical cost

Some general partners (GP) still prefer to hold and report (in their financial statements) investments at cost and some accounting frameworks, for example the old UK GAAP (when they chose not to adopt FRS 26) or if they opt for the flexible investor defined/LPA GAAP, allow that. Whereas some GPs usually think this approach would be easier, in my experience it usually becomes more complicated and messier, as most likely they would still have to report, not in the accounts, but in their quarterly investor reports the manager's valuation.

This means that limited partners (LP) will not be able to reconcile the

quarterly reports against the accounts; and those preparing the financial statements and investor reports still need to keep record of both. As a practitioner, I do not see much value in that approach.

Why would a GP choose to apply or not to apply the HC model? Apart from being easy to account for, the cost is also easy to understand and would not be subject to manipulation, particularly for private equity investments where valuations are highly subjective and the observability tends to be close to zero. But would those advantages be enough to justify the adoption of the HC model?

From an investor's point of view – the main user of the financial statements – would the HC model be useful and enough information for investment decisions/asset allocations to warrant them to using it for the fund financial statements?

According to valuation experts, cost is a one-time arbitrary measure, originating at vastly different points in time that provides little useful information for investors in decision-making; it provides non-comparable data and would result in arbitrary analysis and thus effectively any analysis of data based on historical cost alone would invalidate underlying conclusions.⁴

Fair value

How is fair value better than historical cost? The only way to evaluate and identify which funds are good performers and in which of them and investor would prefer to invest, as well as to assess, measure and compare their interim performance, is to find a basis for measurement that provides comparability. The comparability issue is addressed in fair valuations by calculating the investment's fair value at each reporting date, as opposed to using some 'frozen' valuation, which would be vastly different not only between different funds, but also different for each investment within one fund.

Although comparability and transparency are the most important advantages of fair value, are there any drawbacks of using them? In order to be absolutely objective, it has to be stated that fair value is by far a perfect measurement, particularly for less observable financial instruments that lack objective market data where calculating the fair value might represent a significant challenge.

The volatility that is introduced into the reporting process with the fair valuation is another perceived issue not only for private equity investments; in fact, it is more relevant to quoted investments. This is

one of the reasons why some practitioners called for suspension of fair value/mark-to-market accounting during the financial crisis when the use of fair-value accounting for measuring the value of financial instruments has been a source of controversy. Some even thought that it has contributed to the deepening of the financial crisis with the plummeting valuations wiping off billions of value from financial institutions' balance sheets. There is no need to say that this is a short-sighted opinion; reporting plummeting valuations is just a reflection and not the cause of the financial crisis – this is the very purpose of using fair value to report investments. Consider what David Larsen says about that phenomenon: “Failing to recognise or report volatility when it is occurring is paramount to sticking one’s head in the proverbial sand.” A graphical parallel between fair value and the expiry date on a carton of milk makes such accusations even more ridiculous. Larsen also says: “Removing the freshness date (understand the fair value when measuring financial instruments) will not make sour milk fresh!”⁵

In conclusion, while arguably imperfect, the fair-value concept has been established, evolved over time and has been endorsed by accounting standards-setters, regulators and industry bodies as the best basis for reporting, analysing and monitoring not only private equity investments but also other financial instruments. **Appendix IV** presents some key dates and endorsements by the above-mentioned bodies in the history and evolution of fair-value reporting in private equity.

Convergence between IFRS and US GAAP

IASB and FASB have been working together on the process of convergence between IFRSs and US GAAP since 2002. This convergence process, which has been accelerated during the financial crisis, has probably been best crystallised in the investment-related new standards and amendments to old standards under the two accounting frameworks with a significant US GAAP influence.

These investment-related IFRS standards have been mostly influenced by US GAAP, but also evolved as a result of the global constituents' comments on the IASB exposure drafts (and the relevant amendments to US GAAP) during the process, as follows:

- *IFRS 13 Fair Value Measurement* (US GAAP equivalent: *FASB ASC Topic 820 Fair Value Measurements and Disclosures*; previously *FASB SFAS No. 157 Fair Value Measurement*).
- *IFRS 9 Financial Instruments* (US GAAP: covered in *FASB ASC*

820 Fair Value Measurements and Disclosures, FASB ASC 946 Financial Services – Investment Companies, FASB ASC 815 Derivatives and Hedging, FASB ASC 460 Guarantees, and other FASB ASCs).

- Exposure Draft ED/2011/4 *Investment Entities*, August 2011 with comment period to end on January 5, 2012 (with any resulting requirements to become eventually part of *IFRS 10 Consolidated Financial Statements* and *IFRS 12 Disclosure of Interests in Other Entities*) (US GAAP: covered in *FASB ASC 946 Financial Services – Investment Companies*).

IFRS 13 and FASB ASC 820

IFRS 13 Fair Value Measurement is a result of discussions between IASB and FASB in their joint project on fair-value measurement. These discussions also resulted in FASB amending particular aspects of *Topic 820 Fair Value Measurement* in the FASB Accounting Standards Codification, which codified *FASB Statement of Financial Accounting Standards No. 157 Fair Value Measurements* (SFAS 157)).

Definitions of fair value – similarities and differences

IFRS 13 applies when another IFRS requires or permits fair value measurement or disclosures about fair value measurements; it is not applicable only to financial instruments (financial assets and financial liabilities).

IFRS 13's definition of fair value: "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." This definition is closely aligned with the definition of fair value under US GAAP.

The previous definition of fair value in IFRS was: "The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."

One of the similarities between the new and the old definitions of fair value is that the new one retains the exchange notion contained in the previous definition. Another similarity is that the revised definition also assumes a hypothetical and orderly exchange transaction, meaning that it is not an actual sale, forced transaction or distress sale.

However, there are some significant amendments to the old definition. Probably the most important amendments are that the previous

definition did not specify whether an entity is buying or selling the asset and did not state explicitly whether the exchange or settlement takes place at the measurement date or at some other date. In the new definition, fair value is defined as a current exit price, not an entry (future) price as it might be interpreted in some situations. To elaborate, IASB considered whether differences between the definitions of fair value in US GAAP (an explicit exit price) and IFRSs (an exchange amount, which might be interpreted in some situations as an entry price) would result in different measurements of assets acquired and liabilities assumed in a business combination. This was a particularly important issue because in many business combinations the assets and liabilities are non-financial.⁶

Another deficiency of the previous definition was that it was unclear about what is meant by “settling a liability” because it did not refer to the creditor, but to “knowledgeable, willing parties”.⁷

IASB also concluded that the revised definition of fair value remedies those deficiencies. It also conveys more clearly that fair value is a market-based measurement and not an entity-specific measurement, and that fair value reflects current market conditions, which reflect market participants’, not the entity’s, current expectations about future market conditions.⁸

Fair-value hierarchy

The three levels (Levels 1, 2 and 3) of fair-value hierarchy reflect the observability of current market transactions, contained in IAS 39/IFRS 7 and IFRS 9 and under US GAAP, and have been endorsed in IFRS 13.

Measuring fair value in an inactive market

As a result of the financial crisis and following the recommendations by the Group of Twenty Leaders (G20), the Financial Stability Board’s, IASB and FASB joint Financial Crisis Advisory Group, IASB and FASB worked together to develop common requirements for measuring fair value of assets and liabilities when markets are no longer active.

In response to that call two documents were published: IASB’s staff report on the Fair Value Expert Advisory Panel’s discussion in October 2008; and *FASB Staff Position (FSP) No. FAS 157-4: Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are*

Not Orderly issued in April 2009 and then later codified in the FASB ASC Topic 820. As a result of the responses to the request for views on whether the guidance in FSP FAS 157-4 was consistent with the IASB's Fair Value Expert Advisory Panel's report, IASB included the guidance from FSP FAS 157-4 in the exposure draft.

To address the need for urgent improvement to the transparency of fair value measurement, IASB amended *IFRS 7 Financial Instruments: Disclosures* in March 2009. The amended disclosures about fair value measurements have been relocated to IFRS 13.⁹

Fair-value disclosures

The disclosures in IFRS 13 focus on providing users of financial statements with information about the valuation techniques and inputs used to develop fair value measurements. They also address how fair-value measurements using significant unobservable inputs affected profit or loss or other comprehensive income for the period, which has been achieved by combining the disclosures currently required by IFRSs and US GAAP. In addition, they address additional disclosures that users of financial statements suggested during the comment period, including additional disclosures and reconciliation on Level-3 financial instruments (for example disclosures on valuation process used to arrive at the fair value of financial instruments or generally assets and liabilities, categorised in Level 3).

Effective date

IFRS 13 is mandatorily applicable for annual periods beginning on or after January 1, 2013 with an earlier application permitted. *IFRS 9 Financial Instruments* will be discussed towards the end of the chapter after current classification, accounting and presentation of investments have been explained.

Consolidation exemption

You may be wondering why the consolidation subject is being covered in a chapter on investment. The following is just a brief mention – full details on consolidation are provided in [Chapter 17](#) – and makes specific reference to the fair-value measurement of investments.

Investment Entities

In the US, accounting rules for private equity funds and other alternative investment funds (and investment funds in general) are stipulated in the American Institute of Certified Public Accountant's *Audit and Accounting Guide for Investment Companies (now FASB ASC Topic 946 Financial Services – Investment Companies)*. Under these rules, investment companies defined in the guide (including private equity funds) are exempt from consolidation and are required to report their investments at fair value instead.

Under the existing IFRS rules, there is still no exemption from consolidation for investment entities, similar to US GAAP, but hopefully that will finally change soon. As a result of many comments from constituents on Exposure Draft ED 10 *Consolidated Financial Statements* where no consolidation exemption for investment entities was envisaged, in August 2011, IASB finally agreed (actually that happened a little bit earlier, but it took a while to materialise) to adopt an approach similar to the one used in US GAAP and issued Exposure Draft ED/2011/4 *Investment Entities*, the comment period of which will end on January 5, 2012 with any resulting requirements to become part of *IFRS 10 Consolidated Financial Statements* and *IFRS 12 Disclosure of Interests in Other Entities*.

However, keep in mind that to ensure effective comparisons between entities, the exposure draft would require that entities applying this guidance early also apply all aspects of IFRS 10, *IFRS 11 Joint Arrangements*, IFRS 12 and IAS 28 (as amended in 2011).

Fair value of investments and investment revaluations

Now you are familiar with the need for fair-valuing investments, the following discussion focuses on the process of arriving at that fair value: a process called revaluation. Investment revaluation is generally a process, after initial recognition, of reflecting the subsequent measurement of financial instruments (investments) at a certain reporting date. It is a process that helps us to arrive at the current (at a given reporting date) fair value from the previous reporting date value of an investment by reflecting the increase/decrease in the value of that investment in a certain manner as explained below.

Treatment under different accounting frameworks

The treatment of investments and investment revaluations depends on the accounting framework (GAAP). Following is a brief description of IFRS, UK GAAP, US GAAP and LPA GAAP.

Under IFRS

If you are reporting under IFRS, investments would be treated in the context of the fair-value convention (with only one exception explained below) and the treatment of investment revaluation would depend on the classification of the financial instruments (financial assets in this case) explained below.

Under UK GAAP

If you are reporting under the existing UK GAAP, the situation is a bit more complicated, but is an approach that gives options, namely, in accordance with the UK Companies Act and the existing UK accounting standards (FRS). An entity can choose between the historical cost convention and the fair-value accounting option, and unless the entity is listed, in which case the fair value measurement rules are mandatory, the entity has two options discussed in more detail below.

Under US GAAP

If you are reporting under US GAAP, unlike UK GAAP, fair value accounting is the only option as explained below.

Investor-defined accounting framework/LPA GAAP

If you are reporting under a flexible framework known as investor-defined accounting framework or LPA GAAP, you should follow the provisions of the LPA (although they are rarely very explicit and would often refer to 'Generally Accepted Accounting Principles as agreed from time to time with the auditors') and should ideally disclose it in detail in the notes to the accounts. However, in my experience that detail is not always adhered to either for flexibility reasons (that is, to keep the options open) or because it has been neglected.

Treatment of investments and investment revaluations under IFRS

Under IFRS, private equity investments are treated as financial assets as defined in *IAS 39 Financial Instruments* and the fair-value convention is to be applied (with some limited exception for subsequent measurement as discussed below).

As briefly mentioned earlier in the chapter, what will determine the

treatment of the relevant investment would be the classification of financial instruments.

Classification of financial instruments

Unlike US GAAP, whereby the term 'securities' is interpreted broadly to cover all the investment companies' investments, according to IAS 39 and IAS 32, there are four categories of financial instruments an investment company's investment could fall into:

1. Financial assets at fair value through profit or loss (that either meets one of the conditions specified in paragraph 9 of IAS 30 or is designated as such on initial recognition with some conditions and disclosures attached to it).
2. Available-for-sale financial assets.
3. Held-to-maturity investments.
4. Loans and receivables.

Private equity investments tend to fall within either the first or the second category.

In consolidated financial statements, under the existing standards *IAS 27/SIC 12*, an investment that needs to be consolidated cannot be designated at fair value through profit or loss. The consolidation issue, and a new development that can eliminate that issue, are discussed earlier in the chapter and in great detail in [Chapter 17](#).

Initial recognition and measurement

When initially recognised, financial assets, including investments (as well as financial liabilities), are generally measured at fair value plus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability (acquisition costs). The exception is for financial assets at fair value through profit or loss where acquisition costs are directly expensed to profit & loss. Available-for-sale investments, as well as for held-to-maturity financial instruments and loans and receivables, transaction costs directly attributable to the acquisition (acquisition costs) are capitalised to the value of the investment.

If the financial asset qualifies as a regular-way trade (purchases), the entity needs to make an election, disclosed in the accounting policies, of the accounting for transactions based on either a trade date or settlement date, unlike US GAAP where there is no such option and investment companies need to record their transactions on a trade-date basis.

Derecognition

For regular-way sales of financial assets, similar to regular-way purchases, described above, either a trade-date accounting or settlement-date accounting should be used with a consistent application of the policy for purchases and sales of investments from the same category.

On derecognition the difference between the carrying amount of the financial instrument and the consideration received should be recognised as gain or loss in the profit & loss. To determine the cost of the investment/securities to be written off on derecognition either the weighted average cost or first in, first out (FIFO) cost methods are to be applied, unlike US GAAP where a specific identification method or an average cost method is to be used (*ASC 946-320-40-1*).

Subsequent measurement

After initial recognition, financial assets (including investments) are generally measured at fair value, without any deduction for transaction costs on disposal.

Exceptions to the rule are:

- loans and receivables, which are measured at amortised cost using the effective-interest method;
- held-to-maturity investment, which is measured at amortised cost using the effective-interest method; and
- investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured (and derivatives linked to them), which are measured at cost.

Gains/losses arising from a change in fair value

How we treat gains/losses arising from a change in the fair value of investments depends on the classification of the financial instruments to be revalued:

- For financial assets (and financial liabilities) at fair value through profit or loss, a gain or loss arising from a change in fair value, is recognised in profit & loss.
- For available-for-sale investments recognised net of tax effects in equity and reflected in other comprehensive income (previously 'statement of total recognised gains and losses' (STRGL)), until the financial (investment) has been derecognised when the cumulative gain or loss previously recognised in other comprehensive income is reclassified (recycled) from equity to profit & loss as a

reclassification adjustment. Foreign exchange gains and losses and impairment losses for available-for-sale investments, however, are recognised in profit & loss.

- For financial assets (and financial liabilities) carried at amortised cost (that is, held-to-maturity investment and loans and receivables), recognised through profit & loss when the financial asset or financial liability is derecognised or impaired, and through the amortisation process.

Impairment

An entity assesses at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired and if any such evidence exists, the entity will apply the following rules:

- For an available-for-sale investment, when a decline in the fair value has already been recognised in other comprehensive income (previously STRGL), the cumulative loss that had been recognised is reclassified (recycled) from equity to profit & loss as a reclassification adjustment even though the financial asset has not been derecognised.
- For financial assets (and financial liabilities) carried at amortised cost (that is, held-to-maturity investment and loans and receivables), impairment is recognised in profit & loss, as the carrying amount is reduced either directly or through use of an allowance account and the loss is to be measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (that is, the effective interest rate computed at initial recognition).
- For financial assets carried at cost (that is, unquoted equity instruments not carried at fair value because its fair value cannot be reliably measured), impairment loss is recognised in profit & loss and measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

Impairment reversals

If, in a subsequent period, the fair value of a financial instrument increases or the amount of the impairment loss decreases due to an event occurring after the impairment loss was recognised in profit & loss:

- For available-for-sale financial assets, there is a further distinction

between equity and debt instruments:

- ◆ For available-for-sale debt instruments, impairment loss is reversed and the amount of the reversal recognised in profit & loss.
- ◆ For available-for-sale equity instruments, impairment loss is not reversed through profit & loss.
- For financial assets and financial liabilities carried at amortised cost (that is, held-to-maturity investment and loans and receivables), the previously recognised impairment loss will be reversed either directly or by adjusting an allowance account and the amount of the reversal is recognised in profit & loss, but the reversal does not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed.
- For financial assets carried at cost (unquoted equity instruments not carried at fair value because its fair value cannot be reliably measured), such impairment losses is not reversed.

Presentation

Investments schedule(s)

In terms of presentation, unlike US GAAP, there is no requirement for a schedule of investments to be presented as a separate (primary) statement, but IFRS 7 has certain disclosure requirements that need to be met. These are disclosed in the notes to the financial statements and the investments schedule and the relevant notes (in narrative) is a good place to disclose all the information required by IFRS 7 (for example, risk disclosures and fair-value hierarchies) as discussed in more detail below. In addition, industry best practice states there is at least information about the investments at the reporting date that ties into the statement of financial position, although usually there is a separate period report disclosing the movements on the investment account with all the additions (new investments) and disposals (investments sold) during the reporting period.

Financial assets at fair value through profit or loss* at December 31, 2010								
Investment	2010			2009				
	No. of shares	% ownership	Cost	Fair value	No. of shares	% ownership	Cost	Fair value
Listed investments								
UK								
Investment ARC Limited								
Ordinary shares A	20,000,000	100.00%	20,000,000	30,000,000	20,000,000	100.00%	20,000,000	25,000,000
Ordinary shares B	10,000,000	100.00%	5,000,000	7,000,000	10,000,000	100.00%	5,000,000	6,000,000
Loan notes	-	-	10,000,000	12,000,000	-	-	10,000,000	11,000,000
Total UK	-	-	35,000,000	49,000,000	-	-	35,000,000	42,000,000
France								
Investment DEF Limited								
Ordinary shares	-	0.00%	-	-	10,000,000	100.00%	30,000,000	35,000,000
Preference shares	-	0.00%	-	-	5,000,000	85.00%	7,000,000	8,000,000
Loan notes	-	-	-	-	-	-	10,000,000	10,500,000
Total	-	-	-	-	-	-	47,000,000	53,500,000
Investment GHI Limited								
Ordinary shares	100,000,000	100.00%	30,000,000	30,000,000	-	-	-	-
Loan notes	-	-	30,000,000	30,000,000	-	-	-	-
Total Investment GHI Limited	-	-	60,000,000	60,000,000	-	-	-	-
Total France	-	-	80,000,000	80,000,000	-	-	47,000,000	53,500,000
Total investments	-	-	115,000,000	129,000,000	-	-	82,000,000	95,500,000

Additional information to the investment schedule **					
Investment	Opening balance January 1, 2010	Acquisitions	Disposals	Changes in fair value	Closing Balance December 31, 2010
Investment ARC Limited	49,000,000	-	-	7,000,000	42,000,000
Investment DEF Limited	53,500,000	-	(47,000,000)	(6,000,000)	-
Investment GHI Limited	-	60,000,000	-	-	60,000,000
Total	95,500,000	60,000,000	(47,000,000)	500,000	129,000,000
Investment	Opening Balance January 1, 2009	Acquisitions	Disposals	Changes in fair value	Closing Balance December 31, 2009
Investment ARC Limited	-	35,000,000	-	7,000,000	42,000,000
Investment DEF Limited	-	47,000,000	-	8,500,000	53,500,000
Investment GHI Limited	-	0	-	-	-
Total	-	82,000,000	-	13,500,000	95,500,000

* There is not requirement under IFRS for a schedule of investments to be presented as a separate (primary) statement, the information is provided in the notes to the financial statements.

** This information is not mandatory, but could be provided as additional information

In addition to that, also not mandatory but very useful, a schedule of realisation of investments may also be presented. A schedule of the fair value hierarchy by level (Level 1-3) (in a tabular format) is mandatory under IFRS. Typically all private equity investments would fall withing Level 3.

A sample of investment schedules under IFRS is presented in [Figure 9.1](#).

IFRS 7 disclosure requirements

The approach and the level of investment-related disclosures under

IFRS differ from those under US GAAP. IFRS 7 requirements are not industry-specific and are considered more extensive and onerous than the current requirements under US GAAP. Some of the disclosures, particularly the risk disclosures include not only qualitative but also certain minimum quantitative information, which can be quite challenging with the most prominent example being the sensitivity analysis.

Proper planning for the year-end processes should be in place and well-documented risk policies should be part of the ongoing risk management process.

Some disclosure requirements under IFRS (IFRS 7) are similar to the requirements of US GAAP with the fair value disclosures, including the same three-level fair-value hierarchy that reflects the significance of the inputs used in making the measurements (observability). IFRS also requires the disclosure of fair-value measurements segregated among the appropriate levels within the fair-value hierarchy; a reconciliation of fair-value measurements using Level-3 inputs, including the beginning and ending balances and gains and losses (realised and unrealised) for the period; disclosure of fair-valued assets and liabilities transferred between various fair-value hierarchy levels; and the reasons for such transfer.

In addition, IFRS 7 (IFRS 7.27B(e)) requires that for fair-value measurements in Level 3, if changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, the entity should state that fact and disclose the effect of those changes. These disclosures are part of the audited footnotes.

Realised and unrealised gains (losses) on investments

Unlike US GAAP, there is no requirement to disclose net realised gains (losses) and net change in unrealised appreciation (depreciation) separately, but in reality, they are usually presented separately either in the statement of comprehensive income or in the notes.

IFRS also requires net gains (losses) on foreign currency transactions to be disclosed separately except for those arising on financial instruments measured at fair value through profit or loss (which is basically similar to US GAAP).

Therefore, under IFRS, contrary to US GAAP, the distinction between realised and unrealised gains (losses) is not as important as the distinction between gains (losses) from changes in fair value and gains (losses) from foreign currency transactions.

In addition, paragraph 20(a)(1) of IFRS 7 requires that net gains and losses be separately disclosed for different types of financial assets (for example, at fair value through profit or loss and available-for-sale).

Treatment of investment and investment revaluations under UK GAAP

Under UK GAAP, as briefly mentioned earlier in the chapter, non-listed funds have two options:

Option 1: Fair value option with FRS 26 adoption – to adopt the so-called ‘new’ UK GAAP – a treatment identical to IFRS by choosing to apply voluntarily the fair value option set out in the optional UK standard *FRS 26 Financial Instruments: Recognition and Measurement* which is virtually the same as IAS 39 (with very minor amendments to the original IAS 39) in a package with three other standards as set out in the preface to the standard by the UK Accounting Standards Board (ASB) of IFRS 26. The other standards are as follows:

- *FRS 23 (IAS 21) The Effects of Changes in Foreign Exchange Rates.*
- *FRS 24 (IAS 29) Financial Reporting in Hyperinflationary Economies.*
- *FRS 25 Financial Instruments (IAS 32): Disclosure and Presentation/IFRS 29 (IFRS 7) Financial Instruments: Disclosures.*

For funds that have adopted this package of standards, the treatment is similar to IFRS.

Option 2: Historical-cost option – to decide to stick to the ‘old’ UK GAAP, that is, to apply the historical cost convention. This old-fashioned approach is still used by some funds, but for a fund accountant it might be a bit confusing to try to figure out exactly which standards are applicable and what the rules are.

Generally, the UK historical-cost approach to financial instruments (not only investments as financial assets) includes *FRS 4 Capital Instruments* (a standard with very limited scope and application combined with *FRS 13 Derivatives and Other Financial Instruments: Disclosures* (where applicable) and certain disclosure requirements of *FRS 29* voluntarily.¹⁰

In brief, under this approach private equity investments, which are

generally long-term investments, are treated as fixed-asset investments and like with other fixed assets are required to be recognised in the financial statements at their purchase price. Where a fixed-asset investment has diminished in value, this diminution may be provided for in the profit & loss account, thereby reducing the investment to its recoverable amount. Where the diminution in value is expected to be permanent, it must be recognised. Therefore, in a similar way to other fixed assets, permanent diminutions in value must be taken to the profit & loss account, but also temporary diminutions in value of fixed-asset investments, which would include market-value fluctuations, can also be charged to the profit & loss account. Where a diminution in value of a fixed-asset investment has been charged to the profit & loss account, but the circumstances giving rise to the diminution have reversed to any extent (for example, the investment's market value has increased) the provision should be written back to the extent that it is no longer necessary.

Any amounts of this nature written back should be shown in the profit & loss account or disclosed, either separately or in aggregate, in the notes. In terms of the application of *FRS 11 Impairment of Fixed Assets and Goodwill*, the situation is a little bit complicated; it scopes out investments that fall within FRS 13's scope (FRS 11 paragraph 6). Investments other than subsidiaries, associates and joint ventures are within FRS 13's scope and so FRS 11's impairment provisions do not apply to these (FRS 13 paragraph 5).

However, FRS 11 does apply to investments in subsidiaries, associates and joint ventures.¹¹

Treatment of investment and investment revaluations under US GAAP

Under US GAAP, as mentioned earlier, accounting rules for private equity funds (and generally for investment funds) are contained in AICPA's *Audit and Accounting Guide for Investment Companies* (now *FASB ASC Topic 946*).

Under US GAAP, all securities need to be reported at fair value with changes recognised in earnings – a treatment similar to the treatment of financial assets at fair value through profit or loss under IFRS (or the new UK GAAP with FRS 26 application) with fair valuation at each reporting date and revaluation gain or loss recognised in the profit & loss. There is no option to treat investments as something similar to an available-for-sale financial asset under IFRS with the gain or loss

arising on fair-value revaluation recognised directly in other comprehensive income (OCI) as a component of equity (revaluation reserve) on the balance sheet.

Classification

Unlike IFRS, where under the current standards (IAS 39) there is a number of alternative classifications (for example, financial instruments at fair value through profit or loss and available-for-sale), under US GAAP, the term 'securities', as defined by industry practice, is interpreted broadly to cover all of the investment company's investments.

Initial recognition and measurement

Unlike IFRS whereby financial assets are initially recognised at fair value (for financial assets at fair value through profit or loss) or at fair value plus transaction costs (for financial assets not at fair value through profit or loss (for example, available-for-sale investments)), under US GAAP all investment securities are initially recorded at cost, including commissions or other charges related to the acquisition of investments (*FASB ASC 946-320-40-1*). That is, unlike the financial instruments at fair value through profit or loss under IFRS, for investment securities under US GAAP, acquisition costs are capitalised to the cost of the investment. Since such acquisition costs are not part of the investment's fair value this will result in an unrealised loss on subsequent measurement.

Under US GAAP (*ASC 946-320-25-2*), transactions for private placements or other securities purchased and sold outside of conventional channels (for example, stock exchanges), such as private equity deals/investments, should be recorded as of the date the investment company obtained a right to demand the securities purchased and incurred the obligation to pay the price for the securities purchased.

Generally, under US GAAP, an investment company records all transactions on a trade-date basis, unlike IFRS whereby, as mentioned earlier in the chapter, an entity has a choice and needs to make an election disclosed in the accounting policies, the choice is between trade date and settlement date.¹²

Derecognition

Since, as discussed above, all transaction are recorded on a trade-date basis, derecognition is also recorded on a trade-date basis, unlike IFRS where there is a choice, as discussed above, similar to initial recognition.

On derecognition, the difference between the consideration received or paid and the cost should be recognised as realised gains or losses. To determine the cost of the investment/securities to be written off on derecognition either a specific identification method or an average cost method is used (ASC 946-320-40-1), while under IFRS either the weighted average cost or FIFO cost methods are applied.

Subsequent measurement

All investment securities should be reported at fair value in the statement of assets and liabilities (ASC 946-10-15-2) with changes in fair value recognised in earnings, in a similar way to investments classified as financial assets at fair value through profit or loss under IFRS.

Schedule of investments

With regards to presentation, investments should be presented either on the face of the statement of assets and liabilities or in a separate schedule of investments. There is a minimum requirement to present a condensed schedule with specific presentation and disclosure requirements.

Investment partnerships that are exempt from US SEC registration under the Investment Company Act of 1940, which is usually the case with most of the private equity funds, should report the following (ASC 946-210-50-6):

- Investments by (a) type (b) country or geographic region and (c) industry.
- Name, shares, or principal amount, value, and type for each investment constituting more than 5 percent of net assets and for investments from the same issuer if their aggregate is more than 5 percent of net assets.
- For derivatives, if any, whose fair value exceeds 5 percent of net assets, the range of expiration dates and fair value of a particular underlying asset should be disclosed.
- For investment in another investment company (a fund of funds) whose fair value exceeds 5 percent of net assets, the investment objective and restrictions on redemptions should be disclosed.

A sample of schedule of investments under US GAAP is presented in [Figure 9.2](#).

Realised and unrealised gains (losses) on investments – presentation
Unlike IFRS, net realised gains (losses) and net change in unrealised appreciation (depreciation) should be disclosed separately.

Realised and unrealised gains or losses on foreign currency transactions also need to be distinguished. The foreign currency element of gains or losses on investments may be presented either separately or together with the local-currency market gains or losses on investments.

Figure 9.2: **Sample schedule of investments under US GAAP**

Schedule of Investments * as at December 31, 2010

Investments in	Percentage of total portfolio	Cost in US\$
Direct investments		
Non-marketable securities		
Common stock		
Telecommunications		
Investment ABC		
(Ordinary Shares A: 20 000 000)	25.00%	25 000 000
Ordinary Shares B: 10 000 000)		
	25.00%	
Consumer goods		
Investment GH	50.00%	50 000 000
	50.00%	
Total common stock	75.00%	75 000 000
Loan notes		
Telecommunications		
Investment ABC	12.00%	12 000 000
	12.00%	
Consumer goods		
Investment GH	30.00%	30 000 000
	30.00%	
Total loan notes	42.00%	42 000 000
Total investments in non-marketable securities	117.00%	117 000 000

* Investments are categorised by type and industry with information about geography, number of securities and percentage of total portfolio presented in the Schedule of Investments.

** This should rather be expressed as a percentage of total net assets/partners' capital, but for the purposes of the example it has been expressed rather as a percentage of total portfolio.

*** Cost, although not mandatory, is a useful information to present.

The rules permit either separate or combined reporting of net unrealised gains or losses from investments with net unrealised gains or losses from foreign currency transactions.

The same applies to net realised gains (losses) from investments and net realised gains (losses) from foreign currency transactions and they may be reported either separately or may be combined.

Therefore, to draw a simple conclusion, under US GAAP, the distinction between realised and unrealised gains (losses) is important, while the distinction between net realised and unrealised gains (losses) from investments and net realised and unrealised gains (losses) from foreign currency transactions is not so much so and there is an element of choice in the presentation – separately or combined.

Disclosure requirements

The disclosure requirements under US GAAP are primarily included in the following FASB ASCs:

- *FASB ASC 946 Financial Services – Investment Companies.*
- *FASB ASC 820 Fair Value Measurements and Disclosures.*
- *FASB ASC 815 Derivatives and Hedging.*
- *FASB ASC 825 Financial Instruments.*
- *FASB ASC 275 Risks and Uncertainties.*

Among the most important disclosure requirements are the fair-value disclosures with the disclosure of valuation techniques and inputs used to measure fair value, including fair-value hierarchies (Levels 1, 2 and 3) which are similar to IFRS, a reconciliation of fair-value measurements using Level-3 inputs, including the beginning and ending balances and gains and losses (realised and unrealised) for the period; concentration of credit risk, market risk, off-balance sheet risk, significant estimates, and their uncertainty; and key assumptions used in the determination of fair value.

It also requires disclosure of fair-valued assets and liabilities transferred between various fair value hierarchy levels and the reasons for such transfer.

Recent developments and future trends

In August 2011, IASB released an exposure draft (ED) ED/2011/3 *Mandatory Effective Date of IFRS 9*. It proposed changing the mandatory effective date of IFRS 9 (2009) and IFRS 9 (2010) so that entities would be required to apply them for annual periods beginning on or after January 1, 2015 rather than being required to apply them for annual periods beginning on or after January 1, 2013, with early application still permitted.

Most of us refrain from implementing new standards before the mandatory effective date, unless the new treatment would somehow be beneficial to us, so if you are not adopting an early voluntary

application, you will still be applying the old standards and have enough time to prepare for the new ones, although I would recommend that you start preparing for the implementation.

IFRS 9 Financial Instruments

For those of you who will voluntarily adopt the new IFRS 9 earlier than the mandatory effective date as explained in the preceding paragraph, here is a quick summary of how it is different from IAS 39. The major difference that would potentially impact your accounting, particularly for those who have been classifying their investments as available-for-sale, is that the old-multiple classification and measurement models of financial assets provided by IAS 39 has been replaced by a single model that has only two classification categories:

- Financial assets as subsequently measured at amortised cost.
- Financial assets as subsequently measured at fair value.

Financial assets are classified in one of the above categories based on both:

- The entity's business model for managing the financial assets.
- The contractual cash-flow characteristics of the financial asset.

To classify a financial asset (investment) in the first category, certain conditions need to be met. Unless measured at amortised cost, financial assets (investments) are measured at fair value. An entity may also irrevocably designate, at initial recognition, a financial asset (investment) as measured at fair value through profit or loss, subject to certain conditions and disclosures.

Based on the above outline, it is clear that with the application of IFRS 9 traditional private equity investments will almost inevitably be classified as financial assets measured at fair value through profit or loss. Available-for-sale investments will no longer be available under the new classification. Therefore, no more unrealised gains recognised in equity (revaluation reserve) and reflected in other comprehensive income (previously 'statement of total recognised gains and losses' (STRGL)). With that, further alignment with US GAAP has been achieved.

Summary

In this chapter, I have discussed a number of topics in the context of

investments and investment revaluations from the two bases of measurement: historical cost and fair value. I have addressed what fair value is, why it is the best measure and how the concept of fair value evolved in the context of private equity and the alternative investments asset class as a whole; the convergence between IFRS and US GAAP with the new IFRS 9 (comparison between the new financial instruments standard IAS 39 and the new IFRS 9); IFRS 13 and the consolidation exemption for investment entities recently suggested in ED/2011/4; and the current accounting for investments and investment revaluations under various GAAPs.

Now that you are equipped with the knowledge about the concept of fair value, accounting for investments and investment revaluations, the next chapter will give you insight into a related topic, which is not purely accounting, but is crucial for fund accountants to have at least a certain level of knowledge about in order to be able to understand, appreciate and account properly for the output of that process. This is the process of valuing private equity investments and the concept of valuations.

¹ International Financial Reporting Standards 9 Financial Instruments, version October 2010, IFRS Foundation.

² Ibid.

³ Exposure Draft ED/2011/3 Mandatory Effective Date of IFRS 9, August 2011.

⁴ The Definitive Guide to Private Equity Valuations: An in-depth A-Z guide to valuing investments fairly, Why Fair Value? by David L. Larsen, Edited by Duff & Phelps LLC, PEI, December 2009.

⁵ The Definitive Guide to Private Equity Valuations: An in-depth A-Z guide to valuing investments fairly, Why Fair Value? by David L. Larsen, Edited by Duff & Phelps LLC, PEI Media, December 2009.

⁶ IFRS 13 Fair Value Measurement – Basis for Conclusions, May 2011.

⁷ Ibid.

⁸ Ibid.

⁹ IFRS 13 Fair Value Measurement – Basis for Conclusions, May 2011.

¹⁰ PwC UK GAAP Manual of Accounting, Topic 06. Financial Instruments Including Derivatives, PricewaterhouseCoopers, 2010.

¹¹ PwC UK GAAP Manual of Accounting, Topic 06. Financial Instruments Including Derivatives, PricewaterhouseCoopers, 2010.

¹² PwC Similarities and Differences: a Comparison of US GAAP and IFRS for Investment Companies, PricewaterhouseCoopers, February 2011.

Valuations –

the accountant's perspective

By David L. Larsen, Duff & Phelps LLC

This chapter discusses:

- Precisely why limited partners need fair-value reporting
- Investment valuations within accounts and investor reporting
- Understanding the valuation decision tree
- How fund accountants can work effectively with deal teams
- Commonly used methodologies used in valuing companies
- The importance and relevance of debt valuation

Introduction

One of the most difficult responsibilities faced by a fund's accountant and the fund administrator is articulating to both fund investors and deal professionals the technical background and pragmatic reasons for determining and reporting fair value. At times, it seems as though both general partners (GP) and limited partners (LP) do not fully understand the reporting and disclosure needs of the other.

Further, the failure to communicate why specific information is needed by GP and LP organisations has given rise to more detailed limited partner agreements, requests for side letters, *ad hoc* data requests, and LP initiatives such as the ILPA Private Equity Principles. In addition, new regulation such as the Directive on Alternative Investment Fund Managers (AIFMD) in Europe and the Dodd-Frank Act in the US, have created additional reporting complexity and uncertainty.

While uncertainty and change are ever present, it must be definitively stated that most institutional LPs have need for timely, periodic, robustly estimated net asset values supported by a rigorous measurement of the fair value of underlying investments. Historically, LPs have not always expressed the reasons why they need fair-value reporting. These reasons include, but are not limited to, the following:

- Fair value is the basis investors (LPs) use to report periodic (quarterly/yearly) performance to their investors, beneficiaries, boards, etc.
- Fair value is the best basis for LPs to make apples-to-apples asset-allocation decisions.
- Fair value is an important data point in making interim investment (manager selection) decisions on a comparable basis.
- Fair value is often necessary as a basis to make incentive-compensation decisions at the investor level.
- LPs need consistent, transparent information to exercise their fiduciary duty. Fair value provides such information on a comparable basis for monitoring interim performance.
- An arbitrary reporting basis such as cost does not allow comparability.
- Most investors are required by relevant GAAP to report their investments on a fair-value basis.

Therefore, while arguably imperfect and requiring the exercise of informed judgement, fair value is not only required by relevant GAAP, but is the best basis for analysing and reporting interim performance. Fair value, under both IFRS and US GAAP is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”.¹ This chapter will explore best practice used by fund accountants and fund administrators in determining the fair value of underlying investments and in determining the fair value of limited partner interests.

Investment valuations within accounts and investor reports

One of the best sources of best practice valuation information for alternative asset investors is the *International Private Equity and Venture Capital Valuation* (IPEV) *Guidelines*.² The IPEV Guidelines were created to: “Set out best practice where private equity investments are reported at ‘fair value’, with a view to promoting best practice and hence helping investors in private equity funds make

better economic decisions.”³

Valuing portfolio companies – overview

From a macro point of view, estimating the fair value of alternative asset investments is fairly straightforward. The decision tree shown in [Figure 11.1](#) provides a simple overview of the fair-value estimation process. While the decision tree is fairly simple and straightforward, there have been and will be volumes written on the valuation of alternative investments. Therefore, this chapter is not intended to be a thorough how-to guide on the subject, but provides an overview of valuing alternative investments.

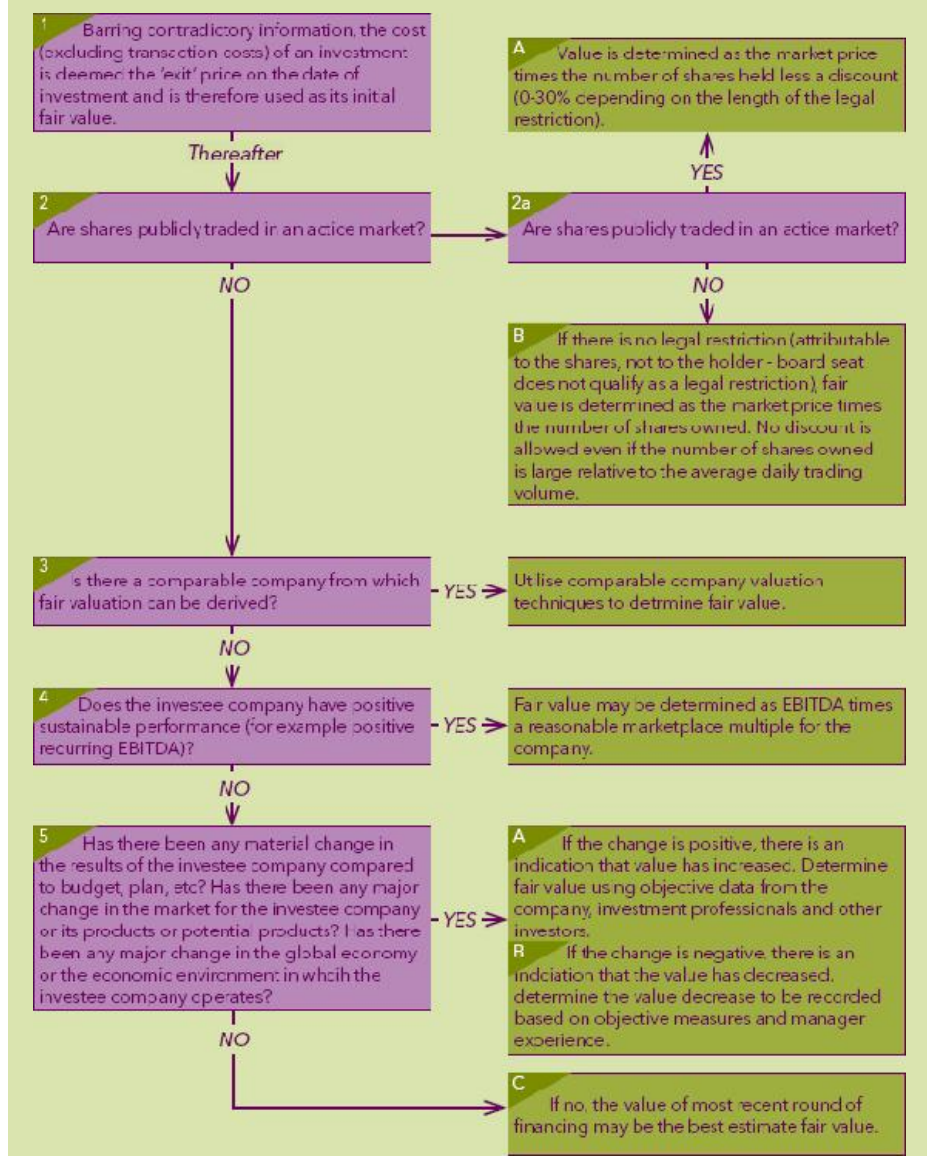
Past practice has changed with the updated accounting standards and IPEV Guidelines. Fair value should be estimated at each reporting date. Some practitioners erroneously believed that cost could be used to estimate fair value for some period of time, even up to a year, after an investment was made. This is not the case. Fair value is estimated at each and every reporting point, even if that reporting point is ten days after an investment was made.

Another common misconception is that a block of publicly traded shares should be valued using a discount if the size of the block is large in comparison to daily trading volume. Blockage discounts are not allowed under the revised accounting standards. Actively traded stock (generally shares traded on an exchange) are valued using price times quantity ($P \times Q$) with no discount.

Using the deal team

One of the most important factors that a fund accountant should take into account when valuing underlying portfolio companies is creating the appropriate balance of deal team input and independent verification or validation. Fund administrators should be able to articulate how the fund manager estimates the fair value of underlying investments. Without providing a clear indication of the valuation responsibilities fulfilled by the administrator, investors may inadvertently expect that the administrator has performed significant valuation procedures itself.

Figure 11.1: Value decision tree



Generally, it is expected that the individuals with the greatest knowledge of the value of an investment are members of the deal team responsible for making, monitoring and eventually exiting the investment. Therefore, best practice uses the information analysed regularly by deal teams in making, monitoring and improving an investment as the basis for documenting the valuation assessments. When deal team members understand that valuation is critical to limited partners, as noted in the introduction to this chapter, and they utilise the same information for monitoring and valuing an investment, the estimate of fair value becomes a key factor in all phases during

lifecycle of an investment.

It is a best practice to have a formalised process with the support of senior management and executed by someone from a position of leadership with oversight of the valuation process as a whole. Additional best practices include the use of independent valuation experts as part of a fund's (even for LPs) internal control processes and the formation of a valuation review committee to address and review valuations prepared by staff and investment managers.

A formalised process typically involves the following steps, which are performed at each reporting period:

Step 1 Investment managers prepare the initial valuations.

Step 2 Non review team examines the initial valuations for completeness and appropriate detail and support.

Step 3 Investment managers discuss each investment with independent valuation expert and/or senior valuation personnel.

Step 4 Independent valuation expert and/or senior valuation leader conduct their detailed review and independent analysis.

Step 5 Feedback provided and considered in the valuation estimate.

Step 6 Non review team makes formal recommendations of fair value.

Step 7 Non review team and independent valuation expert are available to report to the personnel responsible for authorising financial reports and potentially investors so they may respond to any questions appropriately.

Step 8 Ongoing dialogue with all parties regarding open items and monitoring for potential new developments that may occur with the investments during the reporting process.

Step 9 Management sign-off of fair values.

Step 10 As appropriate, by the fund administrator.

Valuing portfolio companies – commonly used valuation methodologies

Accounting standards encourage the use of multiple methodologies in estimating the fair value of an underlying investment. These methodologies include a market approach, an income approach or for certain situations a cost approach.

For most alternative investments a market and/or an income approach are generally used.

Another key best practice in estimating fair value and a new requirement of accounting standards (ASC Topic 820 and IFRS 13) is the need to calibrate the acquisition price of an investment with the valuation model and methodology to be used for future valuations, including identifying market-comparable companies or yields and explaining differences between market data and the multiples implied in the pricing of the deal. Future expectations should also be documented as a reference point and for understanding value going forward. Valuation methodologies should be identified at the time of investment, often during due diligence.

Fair value is based on the concept of what a buyer in the seller's principal market would pay for a given investment at the measurement date. In determining the fair value of an investment, the holder of the investment first needs to determine the principal or most advantageous market. Examples of exit markets would include: the IPO market; the financial sponsor market; the corporate or strategic buyer market; or liquidation of the company's assets in the appropriate markets for the respective individual assets.

Enterprise value

One of the difficulties encountered in valuing alternative asset investments is applying the concept of enterprise value, which is the most relevant measure of the total value of an underlying portfolio company. The value of the entire enterprise may or may not represent the ultimate 'unit-of-account'⁴ as is required by relevant accounting literature. Allocating or apportioning attributable enterprise value between a company's different financial instruments should be relatively straightforward.

However, the accounting standards (ASC Topic 820 and IFRS 13) require that value be determined at a unit of account level. Given the nuances in assessing unit of account, the sum of the parts may not always equal the whole. Therefore, application of informed judgement is necessary in determining the fair value of the component parts of an enterprise.

Using enterprise value to determine equity values

The process for estimating the fair value of an equity investment generally comprises two steps:

Step 1 Estimate the enterprise value of the underlying portfolio

company.

Step 2 Allocate the enterprise value to the equity securities within the capital structure of the company.

The fair value of a specific security or investment is based on the value of the company as a whole after taking into account the financial claim (seniority and other option rights) that exist in preference to the security being valued. Standalone instruments, such as debt or options, generally are valued separately, though enterprise value is a factor in determining their value.

Step 1: Estimating enterprise value

To estimate the enterprise value of a portfolio company that represents a going concern, the market approach and/or the income approach is applied. In some cases, where the subject company may not represent a going concern, the cost approach may indicate the value of the investment.

Market approach

Indications of value are estimated utilising pricing data from comparable publicly traded companies (market-comparable method) or merger & acquisitions of similar target companies (market-transaction method). Consideration is given to both multiples derived using the latest 12-month and forward 12-month financial metrics applied to the results or projections of the subject company to derive an indicative value. While multiples of EBITDA are commonly employed, consideration may be given to multiples of revenue, EBIT, or other metrics as appropriate. In particular, a subject company's industry and financial condition will often dictate the use of the most appropriate pricing multiple. As previously noted, acquisition multiples for the subject company should be calibrated against publicly traded comparable companies. Calibration adjustments may be appropriate.

Such adjustments are intended to represent a sustainable estimate of the financial metric for the subject company and represent the assumptions a market participant would consider in valuing the subject company. In selecting benchmark companies (or transactions) and the corresponding multiples, consideration of the comparability between the public companies and the subject company in the following areas is essential:

- Nature of the business (industry and business model employed).
- Key performance indicators and other value drivers.

- Size.
- Profitability (quality of earnings).
- Operating history and growth opportunities.
- Operating and financial leverage and risk.

Transactions in the subject company's stock

Recent financing rounds and/or other transactions involving the company's stock will provide another indication of value for the company, provided the terms of the transaction represent an arm's length agreement. Consideration of factors such as the timing of the transaction, the rights and seniority of the security, the size of the interest, and the investors involved in the deal should be incorporated into the analysis.

Income approach

Accounting standards encourage the use of multiple methods to estimate fair value. However, it should be noted that generally the income approach or discounted cash flow (DCF) approach to determining value for alternative assets should be used with a modicum of caution. A DCF analysis provides an estimate of the enterprise value of a company that should reflect a long-term outlook for the enterprise. Projected cash flows are estimated and discounted at a risk-adjusted rate of return that accounts for the expectations of market participants.

This rate of return is typically estimated by calculating a weighted average cost of capital, and utilising a capital asset-pricing model, build-up model or similar method to estimate the cost of equity. In estimating the discount rate, consideration should be given to the subject company's stage of development and the timing and riskiness of the projected cash flows.

In analysing the projections to be used in valuing the company, it may be appropriate to adjust the cash flows or the discount rate based on the risk inherent in the projections. Appropriate adjustments are based on the facts and circumstances that a market participant would apply when valuing the company, and are typically based on the comparison of the outlook for the company versus historical performance, industry benchmarks and the performance of companies with similar assets and at a similar stage of development. The length of the projection period should embody the period expected for the company to develop to a steady growth business. A terminal or exit value should exhibit the growth of a mature company.

Any excess returns (return on invested capital versus cost of capital/

discount rate) implied in the exit value of the company should be supported by a qualitative assessment of the company's sustainable competitive advantages. Given the significant judgement required in identifying both projections and discount rates, the income approach is often used to support the market approach.

Assets (and liabilities) that are not accounted for in the projected cash flow (income approach) or market value of comparable companies (market approach) will require an adjustment to the estimated value. Non-consolidated equity investments and idle or not fully utilised assets are typical assets that should be added to the value of a company. Any underfunded pension liabilities, or off-balance sheet obligations, typically represent liabilities that should be subtracted from the enterprise value.

Enterprise value example

The following simplified example helps demonstrate the process of calibrating entry price and estimating periodic enterprise value.

Assume that in September 2007, XYZ Buyout Fund and ZZZ Buyout Fund purchased ABC Cable Company for €600 million, comprising €200 million of equity and €400 million of bank debt. The debt has an eight-year term, 10 percent fixed interest rate, with earlier repayment required after a change in control. XYZ Buyout Fund funded 80 percent of the acquisition (€160 million) and ZZZ Buyout Fund funded 20 percent (€40 million).

As noted above, a key best practice and a newly mandated step by the accounting standards is the calibration of the purchase price to the valuation inputs that will be used to estimate value in the future. Again, while simplified, the following is illustrative:

- ABC LTM EBITDA at September 2007 was €50 million which implies an EBITDA multiple of 12 ($12 \text{ (multiple)} \times 50 \text{ (EBITDA)} = 600 \text{ (enterprise value = purchase price)}$).
- A review of the most comparable public companies indicates a multiple of 10.
- The entry multiple of 12 represents a 20 percent premium over the comparable company multiples of 10.
- The reason for the 20 percent premium would be identified which may be that ABC is growing more quickly, or has key customer contracts, or a better market position, etc.
- Further, the 20 percent premium may represent the fact the XYZ has control of ABC whereas the comparable public companies are valued on a minority basis.

- There are other factors, such as liquidity, which would also be considered. For purposes of this simple example, the above factors are sufficient.

Now assume that the XYZ Buyout Fund must estimate the fair value of its 80 percent interest at September 2011. XYZ Buyout Fund would do the following:

- Determine if there should be any changes to the group of comparable companies.
- Determine the EBITA multiple: assume the multiple for the comparable companies is now 8.
- Determine if the factors supporting a premium for ABC compared to the comparable companies continues to exist. For purposes of this illustration, assume that ABC's growth prospects have diminished and that a 10 percent premium over the comparative set is now appropriate. Therefore, the multiple to be used would be 8.8 (8 comparable company plus 10 percent company-specific premium).
- Determine LTM EBITDA and determine if any adjustments for non-recurring items are warranted.

Reported LTM EBITDA, as of September 30, 2011	€65
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Adjustments	
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One-time gain	€5
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Maintainable EBITDA	€60
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EBITDA multiple (see above)	8.8
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Enterprise value	€528
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Step 2: Allocating enterprise value

Once the indications of value have been derived from the market approach and/or income approach, the results should be compared and evaluated to estimate the fair value for the subject company. In weighting specific approaches, consideration should be given to the reliability of each approach, the quality of data available for each approach, and the application of the approaches to the subject company.

The enterprise value of a company indicates the value of all securities included in the capital structure of a company including debt, preferred securities, warrants, management options and common equity. Once the subject company's total enterprise value has been estimated, the

value is allocated to the securities in the firm's capital structure. The value, after subtracting debt obligations, is allocated to the different classes of equity based on the rights of each class.

Typical rights include liquidation preferences, participation of preferred equity and conversion features.

€300	at face value (assume 100 has been repaid)	
€228	non equity value	
XYZ equity ownership %		80%
Fair value of XYZ's equity ownership		€182.4

The above example demonstrates the impact of several different variables. EBITDA increased by €15 million from 2007 to 2011. However, €5 million of the increase was considered non-recurring. Therefore, only €60 million is used in the calculation of enterprise value. Even though EBITDA increased, the overall market decreased in value as demonstrated by the comparable company multiples decreasing and by the premium associated with ABC company decreasing to 10 percent. The cumulative result of these factors was a decrease of €72 million in enterprise value from the date of acquisition. However, because ABC company was able to pay down €100 million of debt, the fair value of XYZ's equity interest actually increased.

Debt valuation

Historically, the industry took a waterfall approach to valuing debt. The conclusion being that if there was enough enterprise value to repay the debt, then it would be valued at par or face value. However, with the change in accounting standards that imposed a unit-of-account focus, debt from the investor side, for example, the provider of the debt financing, must determine the fair value of the debt instrument on a standalone unit-of-account basis. Therefore, while the waterfall approach is still used to determine if the debt security is impaired, fair value is now determined by a direct approach.

The direct approach to valuing debt securities uses a two-step process similar to the way equity-type securities are valued. Valuation considerations include the following questions when determining the appropriate methodology to follow in estimating the fair value of a debt instrument:

- Is the loan actively traded? If, yes, the loan is valued at the market

trading price

- Is the loan is traded infrequently? If yes:
 - ◆ Are actionable broker quotes based on current market transactions available? If yes, use as an indication of value
- Is the loan is performing? If so, consider:
 - ◆ Is there sufficient enterprise value (or asset value) to cover the loan (principal and interest)?
 - If yes, apply a yield analysis
 - If no, consider also applying a liquidation or restructuring analysis and weighting the result with the yield analysis
- Is the loan non-performing? What is the reason for non-performance?
 - ◆ Minor covenant default (for example, technical default, but still paying, still a viable entity)

Consider the yield analysis, adjust discount rate to account for incremental risk

- ◆ Significant covenant default/payment default
 - Estimate recovery value for the loan based on an enterprise value and/or asset recovery value

Yield analysis

For a performing loan where it has first been determined that there is sufficient enterprise value (or asset value) to cover the outstanding (and expected) amount of debt, the yield analysis is generally considered the most appropriate method to estimate the fair value of the loan. The yield analysis consists of the following steps:

1. Project the cash flows. Typically the contractual cash flows, however, give consideration to:
 - ◆ early pay-off or refinancing;
 - ◆ extensions and/or amendments;
 - ◆ call protection; and
 - ◆ expected maturity versus contractual maturity.
2. Estimate an appropriate discount rate. The discount rate utilised in the valuation will reflect:
 - ◆ the credit quality of the subject loan; and
 - ◆ the market rate for loans with comparable risk and term.
3. Discount the cash flows to present value.

Discount rate and benchmarking

As noted above, the discount rate is a function of the credit quality of the security and the 'market' rate for the given credit quality. The first premise in determining the discount rate as of a valuation is that the original transaction was a 'market' transaction and therefore can be relied on as a data point to calibrate the appropriate discount rate going forward. Expressed differently, it is assumed that the spread over the base rate that was negotiated in the original transaction was 'market' and accounted for the credit quality of the company and the terms of the security relative to the 'market' as of the valuation date. As such, in order to determine the discount rate as of the valuation date, the discount rate needs to be adjusted to reflect:

- 1.the change in credit quality of the security relative to the market since the initial transaction; and
- 2.the change in the 'market' rate for the given credit quality since the initial transaction.

In order to accomplish the steps above, benchmarks for credit quality and market rates first need to be determined as of the initial transaction date and each valuation thereafter.

Although 'shadow ratings' and other metrics can be employed, credit quality is most frequently assessed based on leverage, specifically debt/EBITDA. The rate is simply the 'market' rate or yield observed in the marketplace. There are a number of indices and data sources that can be considered in determining the market rate (for example, Reuters SMI), however, given the private nature of the loans expected to be in private equity funds' portfolios and the limited amount of publicly available data, the best indications of market rates (and leverage) will often come from the deal team's knowledge of the market.

This information may come from transactions that the fund has participated in and/or been able to observe, through discussions with other market participants and through review and analysis of market data sources.

Once the benchmarks are set, the discount rate for a given loan can be determined by adjusting positively or negatively for the subject loan's yield and leverage relative to the benchmark as of the initial transaction versus the yield and leverage relative to the benchmark as of the valuation date.

For credit quality, the subject investment's leverage relative to the benchmarks is compared as of the initial transaction date and the

valuation date.

Additional adjustments to the discount rate may be warranted based on relevant facts and circumstances. Favourable adjustments (for example, decreases to the discount rate) may be warranted for a seasoned loan with very low leverage, and unfavourable adjustments may be warranted for excessive leverage, poor financial performance and other considerations that may lead to an increase in the risk profile of the security.

Debt security valuation example

For illustrative purposes the debt of ABC company as described above is used. Using the assumptions above, the debt security had an initial eight-year term, 10 percent fixed interest rate, with earlier repayment required following a change in control. Further, as of the September 30, 2011 valuation date, €100 million of the principal had been repaid leaving the remaining balance of €300 million. As the loan is performing and because there is sufficient enterprise value to repay the loan, a yield analysis would be used to determine the fair value.

The unit-of-account rules driven by accounting standards require the debt security to be valued on a standalone basis. For example purposes it is assumed that a market participant expects the debt to be repaid in full, in four years and market conditions have changed such that a market participant taking into account risk and required return, now requires a yield of 14 percent. With these assumptions the debt would be priced at 90, or €270 million.⁶ Determining the required market participant yield and expected term require significant judgement. The key point of this example is to demonstrate that the historical waterfall approach to valuing debt is no longer congruent with the revised US and international accounting standards.

Non-performing loans

In valuing non-performing loans, the key consideration is the assessment of potential liquidation value or payment scenarios as the estimation of cash flows will typically depart from contractual cash. While a yield analysis may still be appropriate, other payment or termination scenarios will likely need to be considered. The weighting of different scenarios will be dependent on the borrower's financial condition, the reasons for nonperformance and current market conditions. For loans that are not performing due to a breach of an operating or financial covenant, a yield analysis (with an reasonable adjusted discount rate) will likely remain a valid indication of value, if

the breach is determined to not be critical or may be rectified over time.

Valuing fund interests

Limited partnership interests (LP interests) have historically been valued at the net asset value (NAV) provided to the LP by the GP. IFRS does not currently provide specific guidance on valuing an LP interest. Both the *IPEV Valuation Guidelines* and US GAAP allow the use of NAV under certain circumstances as the basis for measuring fair value.

NAV can be used to estimate fair value if an LP has satisfied itself that reported NAV is as of the LP's measurement date and if the NAV is derived using the fair value of underlying investments. Ultimately the LP is responsible for the determining of fair value in its own financial statements.

LPs should develop a process to bring NAV 'in phase', if needed. LPs should also determine if NAV is based on the fair value of underlying investments by reviewing valuation policies of the GP, corroborating information provided by the GP and available from other sources to ensure it supports the fair value of investments, and accessing information such as the use of a third-party valuation expert and the quality of the fund's auditor.

Conclusion

Establishing policies, executing procedures and reporting results is a key responsibility of fund accountants in order to provide LPs with a rigorous assessment of the fair value of underlying investments. Fund administrators must familiarise themselves with the GP's process to ensure that information presented to investors is not misleading. LPs need timely, supportable values to ensure that their own analytical and reporting needs can be fulfilled.

While judgement is always necessary in developing a fair value estimate, a fund accountant can critically assess fair-value conclusions by honestly answering the following question (with deal team support): What would we pay for this company/investment if we were to invest today? An honest answer to this question provides a final check on whether or not the steps articulated above result in an estimate of the price that would be received in an orderly transaction on the measurement date. Fair value is an important tool for both GPs and

LPs. It is a necessary and helpful basis for reporting. Utilising a process that is rigorous, robust, and which properly applies informed judgement will result in a fair-value answer that is consistent and helpful to the various information needs of investors and managers.

Fair value, while imperfect, is the best measurement basis to meet the many and varied needs of investors and managers. Thorough informed judgement is required to prepare supportable fair-value estimates. Ultimately, best practice fair value estimates require both art and science, that is, judgement and best practice methodologies.

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¹ FASB ASC Topic 820-10-35-1, IFRS 13 paragraph 24.

² <http://www.privateequityvaluation.com/>

³ IPEV Guidelines page 7.

⁴ Both US GAAP and IFRS use the concept of 'unit-of-account' to describe the level of aggregation, or the item which is to be fair-valued. The unit of account could be a single share of stock, or a class of stock, or debt issuance, or a limited partnership interest.

⁵ Some have questioned whether the fair value of debt or the par value of debt should be subtracted from enterprise value to determine the value of equity securities. Generally, if debt must be repaid following a change of control when the enterprise is sold, then the fair value of debt would equal the face value or par value of debt (the amount of debt that would be repaid) and would be subtracted from enterprise value to estimate equity value.

⁶ The present value of the interest and principal cash flows over the next four years discounted at 14 percent: 2012 €30 (interest of 10 percent times remaining principal of €300), 2013 €30 interest; 2014 €30 interest, and 2015 €330 interest and remaining principal.

Expenses and income

By Mariya Stefanova

This chapter discusses:

- Most common types of expenses, provisions and limitations in the LPA
- Organisational/preliminary expenses/establishment costs
- Excess organisational/preliminary expenses/establishment costs
- Fund/partnership/ongoing expenses
- Placement fees
- Deal costs and expenses
- Abort costs and abort fees
- Transaction, monitoring, directors' and other fees earned by the manager
- Investment income
- Dividends
- Investment interest income
- Net income (loss) and allocation of net income (loss)
- Accounting for/recognition of income/revenue (including withholding taxes) and expenses under IFRS
- Accounting for/recognition of income/revenue/turnover (including withholding taxes) and expenses under UK GAAP
- Accounting for/recognition of income (including withholding taxes) and expenses under US GAAP

Introduction

Accounting for expenses and income in private equity funds at the fund level is not a particularly challenging area. This is due to the relatively low volume and diversity of expense and income transactions that a typical private equity fund encounters, but there are still some specifics from an accounting and a limited partnership agreement (LPA) perspective that would require your consideration. A typical private

equity fund would only receive a few expenses-based invoices each quarter; for example legal fees, tax advice, fund administration services (if accounting has been outsourced to a fund administrator) or other professional fees.

Of course the most significant expense is the management fee (if not structured as priority profit share (PPS) in UK funds, in which case it will not be treated as an expense and charged to profit & loss; for more information, see [Chapter 12](#)). In terms of transaction volume they are considered so insignificant that even established providers of specialist private equity accounting software do not include a purchase ledger in their accounting platforms, which allows you to track invoices by number of invoice supplier and other items.

Other entities within the fund structure though, such as the manager, will most likely have a high volume of income and expenses, but this book is focused on accounting at the fund level.

Most common types of expenses, provisions and limitations in the LPA

Organisational expenses, also referred to in some LPAs as preliminary expenses or establishment costs, are incurred when establishing and organising the fund and the sale of interests (in the partnership), including all out-of-pocket, legal, accounting, printing, travel and filing fees and expenses, but usually excluding placement fees. In some LPAs, it is stipulated that organisational expenses should be paid/incurred by the fund and if the general partner (GP), the manager or its affiliates pay on behalf of the fund, the fund should reimburse them by recharging those expenses to them.

Very often in an LPA the amount of organisational expenses to be incurred by the fund is limited either in absolute terms (for example, capped at £1 million) or as a percentage of the size of the fund (for example, 1 percent of the total commitment of the fund) or the lesser of these (for example, up to the maximum of the lesser of 1 percent of the total commitment or £1 million).

Excess organisational/preliminary expenses/establishment costs mean the amount of organisational expenses in excess of the set threshold with these excess organisational expenses to be borne by the GP/manager, often through the management fee/PPS rebate.

Fund/partnership/ongoing expenses

Fund expenses, also referred to in LPAs as partnership expenses or ongoing expenses, are incurred by the fund or arise out of its operations and activities. Examples of fund/partnership/ongoing expenses are as follows:

- Legal, custodial, administrative and accounting expenses, including expenses associated with the preparation of the fund's financial statements and tax returns and reports.
- Auditing, banking and consulting expenses.
- Costs of investor reporting and annual meetings.
- Appraisal expenses related to the fund's assets and potential investments.
- Investment due diligence fees and expenses related to organising special purpose vehicles (SPV).
- Advisory committee expenses.
- Extraordinary expenses under the applicable accounting framework.
- Taxes and other governmental charges, fees and duties payable by the fund (including value-added tax (VAT) for European funds), other than taxes withheld from distributions to the partners or otherwise paid by them.
- Insurance premiums protecting the fund, usually to the extent that the cost of a premium is not reimbursed by a portfolio company or third party.
- Costs and expense of winding up and liquidating the fund. In some LPAs, these wind-up/termination costs/expenses may be separated from the fund/partnership/ongoing expenses.
- Other reasonable costs/expenses that arise out of its operations and activities.

Similar to the organisational/preliminary/establishment expenses, in a typical LPA it is stipulated that these are to be paid/incurred by the fund and if the GP, manager or its affiliates pay on behalf of the fund, the fund should reimburse them, for example by the GP/manager/affiliates recharging those expenses to the fund. Although they are usually both borne by the fund, the fund/partnership/ongoing expenses do not include and are separated from the organisational expenses (and sometimes the wind-up costs/expenses) which may be treated differently for accounting purposes under different GAAPs. Although nowadays they tend to be treated by most recognised accounting frameworks as a current expense as opposed to amortising it over a period of time.

Placement fees

Placement fees are paid to (or due to) placement agents in connection with the marketing and sale of partnership interests. Fund/partnership/ongoing expenses do not usually include placement fees which are usually borne by the GP/manager. The reason being that as they are similar to a marketing expense to market the fund and because the fund expenses are typically funded by the limited partners (LP) through drawdowns. It would not be fair to expect investors to pay the bill for finding other investors.

Deal costs/expenses

Deal costs or expenses are any expenses related to the acquisition of portfolio investments or as lawyers refer to them, 'consummated portfolio investments'. Although I discuss them separately, they often fall within the definition of and are listed in the examples of fund/partnership expenses and would typically include due diligence, legal and tax advice, evaluation, acquisition, holding and disposition in relation to portfolio investments, usually to the extent that such fees and expenses are not reimbursed by a portfolio company or third party.

You need to differentiate between general fund/partnership expenses and deal-related fund/partnership expenses. In my experience teaching fund accountants through practical exercises, it is useful to test their ability to distinguish between general fund/partnership expenses and deal-related expenses/costs. In training exercises, among the invoices they are expected to post, I would usually slip in a deal-related invoice and they are expected to pick up from the description in the invoice that it is a deal fee not a general fund/partnership expense. For example, consider two invoices both for either legal fees or tax advice. One invoice covers work for preparing K1-s or UK partnership tax returns for LPs (or legal advice with regards to the fund structuring/restructuring), which would be treated as a general fund/partnership expense. The second invoice covers structuring deal ABC, which would be a deal expense/cost, and although it might be also treated as fund/partnership/ongoing expense, it still needs to be tracked separately with a consideration for the exact deal it has been incurred in relation to. In general you need to be aware of the invoice's precise description (and detailed schedules to them usually provided by a lawyer, tax advisers and accountants/administrators) in order to be able to account for the expense/cost accurately. Although I said that typically they are part of the fund expenses and therefore charged to the fund, you still need to check the LPA if that is really the case, as the practice may vary and your

particular LPA may stipulate that the manager will have to pick up the bill for them, not the fund.

Abort costs

Abort costs are fees and expenses paid by the fund that relate to proposed but unconsummated investments, or in other words, aborted deals, broken deal, deals that did not complete, usually to the extent that such fees and expenses are not reimbursed by a third party. As with deal costs, they usually fall within this definition and are listed in the LPA as an example of fund/partnerships expenses and would typically include items similar to the deal costs/expenses, only for deals that have been aborted. In terms of the interaction between abort costs, transaction fees and the management fee/PPS, in some LPAs at the end of the investment period any surplus abort costs, which have not been offset against transaction fees, are to be treated as fund/partnership/ongoing expenses of the partnership (if previously treated differently).

Abort fees

Abort fees are different from abort costs in that they are income for the manager/GP from the portfolio company as a reimbursement for the abort costs, while the abort costs are expenses/costs usually incurred by the fund.

Management/advisory fees

Management/advisory fees, unless structured as a priority profit share (see [Chapter 12](#) for more details), are usually charged to profit & loss. Although even in some US funds the accounting treatment may be similar to the UK priority profit share as explained later on in the US GAAP section of this chapter.

Transaction, monitoring/directors' and other fees earned by the manager

These are not expenses from the fund's perspective; they are income earned by the manager, GP or any of their respective affiliates. Remember to carefully read the LPA to understand how transaction, monitoring/director, investment-banking, break-up, advisory and other fees received by the manager/GP interact with the abort costs and the

management fee/PPS through the management fee/PPS rebate as explained in more detail in [Chapter 12](#). As a reminder, usually any excess of transaction fees over the abort costs is split between the fund and the manager/GP, which is in some cases is 50:50 while in others it mirrors the 80:20 carry ratio, with 80 percent going to the partnership and 20 percent to the manager/GP with the fund's share of any such amount being repaid to the fund through a reduction in the management fee/PPS (that is, the management fee/PPS rebate).

Income

Considering the type of activities managed by private equity funds, the income in the profit & loss would typically consist of investment income, although there will probably be some other items such as bank interest, which is different from interest on investments/investment interest income, and occasionally some other items.

Investment income

For other funds (including real estate and infrastructure funds), the income items would be slightly different, but since this publication is focusing on the private equity asset class, I'll focus on the income for a typical private equity fund. Similar to expenses (and even more so in some cases), investment income is not particularly diverse and more or less consists of:

- interest income from investments (not bank income);
- dividend income; and
- other investment income.

Net income (loss)

Net Income (loss) is usually defined by the LPA as the amount of net income or net income loss calculated by subtracting (a) the expenses and losses (other than capital losses, expenses included in the acquisition costs of portfolio investments and expenses associated with the disposal of portfolio investments) from (b) the gross income of the fund, being amounts other than capital gains which are determined by the GP to be in the nature of income.

Allocations of income and expenses (net income)

As explained in previous chapters, in a partnership every partner has

an interest not only in every asset and liability of the partnership but also in the net income (net income loss) and capital gains (capital losses). In other words in the net assets/net asset value (NAV) of the fund, which means that the remaining (after the allocation of PPS) net income (and gains) needs to be allocated to each partner following the rules in the LPA. This allocation is different (and is in a different part of the LPA) from the allocation of cash (cash distribution or cash waterfall). Although the aim is that at the end of the funds' life both are aligned, during the life of the fund, one may differ from the other. For more information on allocations refer to [Chapter 16](#).

Accounting for/recognition of income and expenses

There is nothing particularly specific in private equity accounting in terms of accounting for expenses and income. Generally Accepted Accounting Principles (GAAP) typical to the relevant applicable accounting framework, though, need to be observed; for example the accrual/accruals basis of accounting, which generally exists in all recognised accounting frameworks.

Some general points

In practice, accounting for some of the expenses (particularly expenses covered by invoices) is done on a cash basis when invoices are paid. Personally, I am not a great fan of cash accounting but in some cases it may make sense. For example, if your accounting is outsourced and you are charged, say, £15 for each posting, if the overall impact would not be material it is probably justifiable and may save you some money or resources to adopt cash-basis accounting for your invoices/expenses. My personal preference would be to post the invoice and the relevant payment separately, particularly when the invoice is denominated in a different currency; however, posting it separately would result in some foreign exchange differences.

You may have some strong reasons for not posting separately. Unless the invoice date (or the rendering of services) is far apart from the settlement date or if the invoice is in a foreign currency and accounting for the two transactions separately would result in a material foreign exchange difference (or the cumulative foreign exchange difference for all such similar expenses is material), you may be able to justify your decision to post expenses on cash basis, but I would suggest a disclosure if you are claiming a full application of an accounting

framework that requires accrual/accruals basis of accounting for expenses.

As always, do not forget to consult your LPA about which expense (not so much income, because there is not much room for discussion there, as it is relatively clear what income is earned by which entity within the fund structure) items are to be incurred by the fund and which should be incurred by the GP/manager/affiliates.

Accruals and prepayment

Accruals and prepayment together constitute another area where there is nothing specific for private equity accounting. So, my advice would be to complete them the way you would usually do it for other entities, just do not forget if you have not received the invoices yet or if you have not paid certain fees (particularly when you account for the invoices on a cash basis) to double-check if you are not missing an accrual. For example, audit fees are often missed out or the fund administrator's fees for the period or any legal or tax advice services that have been rendered or applicable to the period. Ideally check the next quarter's bank statements to make sure that you are not missing any expense that should be accrued for in the current period.

Also do not forget prepayments; for example if you had the annual insurance premium paid in January and accounted for as a prepayment, do not forget to release the relevant portion in each period, whether each quarter or month.

Deferring expenses

An interesting point is raised about deferring expenses in *Private equity accounting – auditor's perspective* by Nat Harper of KMPG (see [Chapter 20](#)).

Deal expenses/cost

It is advisable for a number of reasons to track deal expenses on a deal-by-deal basis, examples of reasons for such good practices follow:

- **Reclassifying deal costs** to abort costs – if the deal team is working on a certain deal and accumulating costs/expenses both at the fund level and/or at the manager level and if the deal does not

complete, they will have to be reclassified as abort costs.

- **Recharges** – some managers recharge to the fund deal expenses/cost accumulated at the manager level (for example, travel and subsistence incurred in relation to a certain deal by members of the deal team).

- **Capitalising deal/acquisition costs** – if the applicable GAAP and/or accounting policies require that acquisition costs are capitalised to the investment.

- **Management accounting purposes** – if the GP/manager simply wants to keep track and analyse the deal expenses on a deal-by-deal basis for management accounting.

For any or all of the above reasons, I would strongly recommend that you have at the very least a reasonable system for recording and tracking deal costs/expenses on a deal-by-deal basis. Obviously, the more complex your requirements, the more sophisticated your system needs to be.

IFRS

As noted above, for expenses and income, generally accepted accounting principles detailed in IFRS have to be applied.

Income/revenue and income recognition

Generally, in IFRS, revenue (that is income that arises in the course of an entity's ordinary activities), is defined as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those activities result in increases in equity, other than increases relating to contributions from equity participations.¹ Revenue is measured at the fair value of the consideration received or receivable.

Investment income

In terms of timing of the recognition of the revenue from dividends and investment interest, with reference to paragraph 29 of *IAS 18 Revenue*, there are two conditions that both need to be met:

- When it is probable that the economic benefits associated with the transaction will flow to the entity.
- When the amount of the revenue can be measured reliably.

Referring to the first of these two conditions, paragraph 34 of IAS 18 stipulates that revenue is recognised only when it is probable that the economic benefit associated with the transaction will flow to the entity. However, when an uncertainty arises about an amount already included in revenue actually being collectible, this amount or the amount most probably to go uncollected should be recognised as an expense, rather than simply an adjustment of the amount of revenue originally recognised.²

Dividend income

Paragraph 30(c) of IAS 18 refers to dividends which are to be recognised when “the shareholder’s right to receive payment is established” – whether the declaration date (when the dividend is announced) if it is unlikely that the securities that you hold will change hands, the ex-dividend day (the first day on which the buyer of stock is not entitled to receive the next dividend, usually two days before the record day and after declaration day) or any other date – whichever meets the criteria definition, typically ex-dividend day would meet the definition. Paragraph 30(a) of IAS 18 generally covers interest to be recognised using the effective-interest method from the date of purchase, which is also set out in paragraph nine of IAS 39 specifically for financial instruments.

Investment interest income

IFRS also requires separate presentation of interest income and foreign currency exchange gains and losses except when the financial assets are carried at fair value through profit or loss, which means that if you treat your investments as available-for-sale, exchange differences arising on translating those investments as well as the current period amortisation on the it would need to be presented separately in the statement of comprehensive income.

Withholding taxes

Under IFRS, income is presented gross (of the tax expense – the withholding tax) in the statement of comprehensive income. The withholding taxes should be presented as a separate component of income tax (expense) for the period, required by paragraph 82(d) of IAS 1, which means that they should be tracked and recorded separately.

Expenses

With reference to IFRS Framework (paragraph 94), recognising expenses result directly from recognising and measuring assets and liabilities. Expenses are recognised in the statement of comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability that can be measured reliably has arisen.

Management fee

Management fee, unless structured as a priority profit Share – a typical structuring in the UK, should be treated as an expense, as explained in detail in [Chapter 12](#).

Carried interest

As explained in detail in [Chapter 14](#), there is an argument that, under IFRS, carried interest, “unlike US GAAP where a carried interest may be presented as an allocation, a carried interest under IFRS will always be reflected as an expense (when the appropriate thresholds have been met)”³ that is after the second trigger point which is pass hurdle, but in practice most funds tend to present carry as an allocation. To form your opinion on which approach you should follow, read [Chapter 14](#) and discuss with your auditors.

UK GAAP

Back to fundamental principles. With the accruals basis of accounting as a long-standing fundamental accounting concept and a basic accounting principle in the UK Companies Act, Financial Reporting Standard (FRS) 18 contains an explicit requirement for all entities whose financial statements are intended to give a true and fair view to adopt the accruals basis. FRS 18 specifies that the accruals basis should reflect the asset-and-liability approach advocated in ASB’s Statement of Principles.

An interesting fact is that FRS 18’s description of the accruals basis excludes any reference to matching revenues and costs. This is another fundamental principle that exists in recognised accounting frameworks (for example, IFRS) because ASB believes that is an inappropriate accounting principle: “The accrual basis of accounting requires the non-cash effects of transactions and other events to be reflected, as far as is possible, in the financial statements for the

accounting period in which they occur...”⁴

ASB's Statement of Principles explains that revenue-matching and expenditure-matching should be restricted so that only items that meet the definitions of assets and liabilities, and satisfy their respective recognition criteria, should be recognised in the balance sheet. This in turn affects how revenues and costs are recognised in the profit & loss account.⁵

Income, revenue and turnover

Under UK GAAP, according paragraph 4.37 of SoP, income and gains are increases in ownership interest not resulting from contributions from owners.

With regards to revenue, in UK GAAP, according to FRS 5 App Note G4 revenue is recognised by a seller “under an exchange transaction with a customer, when and to the extent that, it obtains the right to consideration in exchange for its performance”. FRS 5 App Note G4 also explains that at the same time with the revenue recognition, a new asset, usually a debtor, is typically recognised.

However, FRS 5 App Note G11 suggests that revenue and turnover are not to be used interchangeably and the turnover is defined as “the revenue resulting from exchange transactions under which a seller supplies to customers the goods or services that it is in business to provide”, a definition which is supported by the Companies Act 2006. Therefore turnover is rather considered to be a sub-division of revenue (not the same as revenue). Continuing this argument, the distinction between turnover and other gains (losses) has always been a bit unclear and that is why there has always been a confusion whether or not gains (losses) are to be distinguished from turnover, in terms of presentation in the profit & loss, and decisions about whether certain items within or outside of turnover should be made in the context of the business activities of the reporting entity, with some entities presenting it within their turnover and for other outside of turnover, depending on their core business. In the context of a private equity fund/investment entity, considering the nature of their core activities, gains (losses) from investments should be presented within turnover. The same reasoning should apply to interest and dividends from investments.

In terms of measurement, similar to IFRS, revenue (income) is recognised at the fair value of the right to consideration as per FRS 5 App Note G7.

Dividend income

The treatment of a dividend is similar to IFRS. Treatment of dividends in a recipient's financial statements (in the fund) will follow that in the paying company (in the portfolio company), that is, dividends receivable (and dividend income, respectively) will be recognised "when the shareholder's right to receive payment is established". That definition is defined in *FRS 26 Financial Instruments: Recognition and Measurement* (if adopted), which is literally *IAS 39 Financial Instruments: Recognition and Measurement*, with very immaterial amendments made by the UK ASB, and for that reason it is exactly the same as in IFRS. According to the report, *PwC UK GAAP Manual of Accounting, 2009 Revenue Recognition*, in the UK the right to receive payment is established, for interim dividends, when they are paid and, for final dividends, when they are approved by shareholders at an annual general meeting.⁶

But since the definition is the same as in IFRS I do not see why the ex-dividend date cannot be used. In my opinion the former approach is probably too simplistic and does not take into consideration a scenario in which the security/financial instrument is likely to be sold between the declaration date and the ex-dividend date.

Investment interest income

Similar to treatment of dividends, treatment of investment interest is similar in UK GAAP to IFRS. In practice, though, some funds prefer to simply accrue for interest income on loan notes (or other debt instruments), while other funds factor it in the interim valuation, which means it is included in the revaluation reserve (unless FRS 26 has been adopted and investments are treated as financial assets at fair value through profit or loss in which case revaluation goes through profit & loss) that is adjusted accordingly when cash is received. Whatever the case, you should be careful not to double-account for it. If it has already been factored in the valuation and you revalue the loan notes based on the numbers provided by the valuation team, then you should not be accruing for that interest and vice versa.

You should also disclose in the notes to the accounts (in the accounting policies note) which method you are using.

There are also funds that prefer to account for interest on a cash basis, which is acceptable if they are applying a flexible LPA GAAP and disclose that accounting policy in the notes to the accounts. However, if a fund is reporting under a recognised GAAP, for example UK GAAP

or IFRS, it would have to account for them on an accruals basis or by using the effective-interest method. If a fund insists on using the cash-accounting policy, it will need to disclose that departure from the applicable standards in the notes to the accounts.

Withholding taxes

Under UK GAAP, as paragraph 9 of *FRS 16 Current Tax* requires, incoming dividends, interest or other income receivable should be recognised at an amount that includes any withholding taxes.

US GAAP

Dividend income

US GAAP is in essence similar to IFRS and UK GAAP in terms of the timing of the recognition of dividend income, but it just uses a different wording. FASB ASC 946 expressly states that dividend income is recorded on the ex-dividend date, while IFRS, as you have seen previously, uses a more generic wording (“when the right to receive payment is established”) allowing room for interpretation, but in practice, as mentioned previously, ex-dividend date typically meets that definition.

Dividends from affiliates and controlled companies should be disclosed not only according to FASB ASC 946, but also *FASB ASC 850 Related Party Disclosures* and Rule of Regulation S-X for SEC registrants (if you are one).⁷

Interest income

Interest income, including amortisation of premiums and accretion of discounts (where applicable), is generally accrued on all debt securities (for example, loan notes and bonds). Similar to IFRS and UK GAAP, interest is to be accrued and recognised using the effective-interest-rate method, which means that discounts and premiums, if any, are amortised (ASC 946-320-35-20). However, differences may arise in the detailed application of the effective-interest-rate method. Collectability of interest also needs to be considered in making accruals and accrued interest should be written off if and when it becomes likely that the interest will not be collected in line with the guidance provided in *FASB ASC 450 Contingencies*.⁸ As with dividends, interest earned on securities of affiliates and controlled

companies should also be disclosed separately.⁹

Other investment income

Although it may not be applicable to most of the funds, occasionally some funds would have other investment income, for example fee income from securities loaned and from miscellaneous sources. In these cases, individual items if material should be disclosed separately. Again, where applicable, Rule 6.07 of Regulation S-X, mentioned above, requires separate disclosure of any category of income which exceeds 5 percent of the total investment income.¹⁰

Withholding taxes

Unlike IFRS, under US GAAP, withholding taxes are deducted from the relevant investment income, for example on receipt of a dividend from a portfolio company. It is disclosed as either parenthetically or as a separate contra item. The difference is only presentational and should not have any impact on the net profit or loss for the period.

Expenses

As stated by FASB ASC 946, there are certain expense items that are commonly reported separately in the statement of operations; a list of those items is provided in AICPA's *Audit & Accounting Guide for Investment Companies*.

Similar to income treatment, FASB ASC 850 requires that amounts paid to affiliates or related parties, such as management, advisory, administration and other fees should be disclosed accordingly. Also, significant provisions of related-party agreements, including the basis for determining these fees, should be described in a note to the financial statements.¹¹

Again, Rule 6.07 of Regulation S-X (where applicable), requires separate disclosure of each expense exceeding 5 percent of the total investment expenses. Additionally, the notes to the financial statements should include the total amounts by which expenses are increased and should list each category that is increased by at least 5 percent of total expenses.¹²

Management/advisory fees

Typically, management/advisory fees are treated as expenses, although there are some funds in which they are structured and treated similarly to the UK priority profit share (see [Chapter 12](#) for more information), that is, through the allocation of net income (and net gains) from the limited partners' capital accounts to the GP's capital account. FASB ASC 946 notes that such amounts should be presented in either the statement of operations or the statement of changes in partners' capital as stipulated by the LPA and the method of computing such payments or allocations should be described in the notes to the financial statements.¹³

Carried interest

As explained in detail in [Chapter 14](#) and as noted in the IFRS section of this chapter, under US GAAP, carried interest is typically treated as allocation of profits (gains), not an expense which is the more typical treatment for offshore funds.

Summary

In this chapter, I have discussed the most common types of expenses, provisions and limitations in the LPA with regards to expenses. These comprise organisational expenses/preliminary expenses/establishment costs and excess organisational/preliminary expenses/establishment costs, fund expenses/partnership/ongoing expenses, placement fees, deal costs/expenses, abort costs and abort fees, transaction, monitoring/directors' and other fees earned by the manager, as well as investment income, including dividends and interest income. I have also discussed the concept of net income/net income loss and briefly mentioned the allocation of net income/net income loss, explained in more detail in [Chapter 16](#). And finally I have presented a general overview of the accounting for/recognition of revenue and expenses under various recognised accounting frameworks – IFRS, UK GAAP and US GAAP.

Now that I have briefly mentioned the treatment of management fees and its other form, that is the PPS which is most common in the UK, in the next chapter I will discuss in more detail the management fee and PPS, considerations for using one form over the other, and calculation and accounting treatments with plenty of practical examples.

¹ IAS 18 Revenue, version January 1, 2011 by IASB with amendment resulting from IFRSs issued up to December 31, 2010.

- ² Ibid.
- ³ PwC Similarities & Differences: A Comparison of US GAAP and IFRS for investment companies, PricewaterhouseCoopers LLP, February 2011.
- ⁴ PwC UK GAAP Manual of Accounting, 02. Accounting Principles and Rules, December 2009.
- ⁵ Ibid.
- ⁶ PwC UK GAAP Manual of Accounting, 09. Revenue Recognition, December 31, 2009.
- ⁷ AICPA Audit & Accounting Guide for Investment Companies, May 1, 2011.
- ⁸ PwC Similarities & Differences: A Comparison of US GAAP and IFRS for investment companies, PricewaterhouseCoopers LLP, February 2011.
- ⁹ Ibid.
- ¹⁰ AICPA Audit & Accounting Guide for Investment Companies, May 1, 2011.
- ¹¹ Ibid.
- ¹² Ibid.
- ¹³ AICPA Audit & Accounting Guide for Investment Companies, May 1, 2011.

Management fee versus priority profit share

By Mariya Stefanova

This chapter discusses:

- What a management fee is and its precise function
- How a management fee compares to a priority profit share
- The rationale for the priority profit share
- Calculating a management fee and a priority profit share
- A detailed example of calculating a management fee
- Accounting practices for a management fee
- Accounting details for a priority profit share
- Detailed impact on financial statements in calculating a priority profit share

General principles and future trends

The management fee, which is levied annually by the general partner in managing a fund, is like a basic salary for the general partner/manager, intended to provide a basic compensation covering its time and expertise in operating the fund. Its purpose is to support the general partner's ongoing activities by covering the basic costs and expenses of running and administering the fund. It is designed to cover only basic expenses such as the firm's investment professionals' salaries and the back-office personnel's, rent, furnishing, utilities and other office expenses, travel and even entertainment expenses.

You will notice in the preceding paragraph the word 'basic' appears four times, but there is a good reason for the repetition. When designing the management fee, an important presumption is that it is

basic compensation to cover basic costs, which means that it should not be excessive. Private equity is performance-driven and the incentive for the manager to do a great job does not come from the management fee, but from another source, based on its performance, and that source is the carried interest, which will be discussed length in [Chapter 14](#). Therefore, the presumption is that a manager should not be making significant profits by levying the management fee.

The management fee is ultimately borne by limited partners, which is funded through drawdowns – limited partners prefer to compensate managers' through carried interest, not the management fee. There has been a significant pressure exercised by limited partners over the last few years, particularly since the global financial crisis started biting and the fundraising environment deteriorated. Pressure has centred on alignment of interests, including management fees, between limited partners and general partners, which crystallised in a set of principles called *Private Equity Principles*, which were first issued in September 2009 and updated in January 2011 by Institutional Limited Partners Association (ILPA). Since these principles reflect the views of many representative, large institutional investors, the management fee is an integral issue. As they must have considered that the management fee charged by funds has not always been fair, ILPA has defined the principles with regards to the management fees as follows:

“Management fees should cover normal operating costs for the firm and its principals and should not be excessive.”

Private Equity Principles Version 1.0 (slightly modified in Version 2.0)

“Management fees should be based on reasonable operating expenses and reasonable salaries, as excessive fees create misalignment of interest.”

“The management fee should encompass all normal operations of a general partner to include, at a minimum, overhead, staff compensation, travel, deal sourcing and other general administrative items as well as interactions with limited partners.”

Private Equity Principles Version 2.0

I have seen signs of limited partners trying to endorse these principles and to negotiate new limited partnership agreement (LPA) terms with respect to the management fee. Going forward, limited partners are likely to exert more control over the fairness and non-excessiveness of the management fee. So, the traditional model of a fixed commitment

of 2 percent (for the investment period) management fee may no longer be an industry standard as some investors would like to see it reduced towards 1 percent, or even lower.

Another of the principles issued by ILPA is:

“During the formation of a new fund, the general partner should provide prospective limited partners with a fee model to be used as a guide to analyze and set management fees.”

Private Equity Principles Version 2.0

Therefore, as well as the existing model being challenged in the future, there are some emerging alternative practices such as the budgeted management fee, which is based on the fund's operating budget, or management fees based on a reimbursement of expenses to prevent the management fees from becoming excessive (this approach is used in the hedge fund world, but is not so common in the private equity industry).

Management fee versus priority profit share

What is a priority profit share (PPS) and how is it different from the management fee?

The PPS is characteristic of UK funds and it is often referred to as the general partner's share (GPS) or general partner's profit share (GPPS), but whatever term is used (I refer to all of these terms interchangeably, although I have generally tried to stick to the term PPS), it is essentially the same. The PPS is a form of management fee structured as an annual, guaranteed profit share (in addition to carried interest) of the limited partnership's profits, drawn periodically by the general partner. The PPS is paid to the general partner ahead of profits paid to the limited partners. In the early years of a fund, when there may be no profits, the PPS is distributed to the general partner and is recorded as a loan (as a typical LPA would stipulate), essentially a 'special' interest-free loan (or rather a cash advance) that is repaid by the general partner only as a charge against the fund's future profits. It is funded by the limited partners until the partnership starts generating profits and will not be subject to repayment in case that the fund is wound up prematurely, that is, before it starts generating profits or if there are not enough profits to cover it at the end of the life of the fund.

What is the rationale for the priority profit share?

You may ask yourself why the management fee would be structured any differently in the UK from elsewhere. The reason for the UK approach is tax-related: structuring the distribution to the general partner as a guaranteed share of the fund's profits reduces the risk that UK value-added tax (VAT) is imposed on this annual amount distributed by the fund. Since the PPS is not a fee charged by the general partner, no invoices are raised and therefore no VAT is charged. For US funds managed from within the US, for instance, the absence of a VAT regime in the country makes it unnecessary to adopt a similar structure with respect to amounts paid by the fund as management fees. In addition, instead of being taxed on fee income, the general partner may enjoy the more beneficial tax regime in treating the PPS as a gain.

And another added benefit for general partners is deferring tax payments in the early years of the fund when there is no profit.

Management fee/PPS calculation

The management fee calculation is fairly simple. Often it is initially based on a flat percentage of the limited partners' total commitment to the fund (that is, the fund size) for periods before the end of the investment period and it is often scaled down in later years to reflect a reduced work load. The end of the investment period usually serves as a cut-off when the management fee is reduced and is calculated as a percentage of the aggregate acquisition cost of unrealised portfolio investments adjusted with the writeoffs, or in other words, of the actively invested capital, which is considered to be a fairer basis than the commitment.

In the event of winding up a portfolio company or a permanent write-off or write-down of an investment, this event is usually treated as a realisation and the investment acquisition costs of are excluded from the basis of calculating the management fee/PPS.

In cases where the private equity firm is managing several (subsequent) funds, usually called successor funds, the general partner's management expenses are shared on a *pro rata* basis with the other funds. Paying management fees for successor funds generally should not start until the fund's investment activity starts.

It may also be tapering off in situations when a key-person event takes place or when the limited partners vote the termination of the

investment period earlier than originally foreseen.

The general partner/manager will usually receive an annual management fee from the fund typically paid in quarterly but sometimes semi-annual or annual instalments, predominantly at the beginning of the period (for example, on the first day of each quarter).

Management fees tend to run in the 1-2.5 percent range depending on the fund size, of the fund complexities and manager's reputation, but the most common scenario is 2 percent as mentioned above.

Keep in mind that it is not always that simple. A typical calculation would, for example, also factor in transaction and other fees (for example, monitoring fee, advisory fees and fees for investment banking-like services) that the manager or its associates might have provided to portfolio companies, as well as costs incurred aborted deals.

In the 1980s, it was common for buyout funds to earn fees for providing investment banking-like services for arranging transactions, such as initial public offerings (IPO) or mergers and acquisitions (M&A). Arranging these deals provides a significant additional cash flow for them without impacting the calculation of the management fee in the way that it currently does. Limited partners were not very happy about this approach – they considered these transactions diverted manager focus from their main responsibility of managing the fund's portfolio investments.

In the 1990s, the pendulum swung from general partners towards limited partners and they won the right to share in such fee income and to make this activity less rewarding for the manager/general partner and/or its associates. This discouraged them from participating in such activities, which is how the current usual practice of transaction fees being applied to usually the future management fees became a popular approach. In other words, transaction fees (or at least a certain proportion of them) are offset against future management fees.

The most common split is 50:50, that is, 50 percent is offset typically against the next period's (usually a year, although in some LPAs it is the current period, adding complication) management fee and 50 percent is left to the manager/general partner or their associates that provided the services. There is another argument that the split should be 80:20 (that is, 80 percent offset against the management fee in favour of limited partners and 20 percent for the manager), thus mimicking the typical carried interest.

Lately, however, as a result of another pendulum swing towards limited partners, reflecting concerted effort by some large institutional investors wishing to align investor interests with general partners', an argument that 100 percent of fees should be offset against the management fee has become more popular. In the future, considering the ongoing tough fundraising conditions, some general partners may capitulate to that idea. ILPA *Private Equity Principles* promote the following principles:

“Transaction, monitoring, directory, advisory, exit fees, and other consideration charged by the GP should accrue to the benefit of the fund.”

Private Equity Principles Version 2.0

For now, the dominant practice is that these fees are accrued by the manager and 50 percent (or 80 percent when mimicking carried interest) is offset (sometimes is also called a rebate) against the management fee. The following example illustrates how this usually works in a management fee calculation.

Management fee calculation – an example

Based on an excerpt from an LPA and some additional information shown below, the following example calculates the management fee/GPS from inception to December 31, 2010.

The following excerpt is a typical example of LPA clauses with regards to the PPS/GPS:

8.1. Allocation of the General Partner's Share

The General Partner shall be entitled to receive and, as a first charge on Net Income and Capital Gains, there shall be allocated to the General Partner in respect of each Accounting Period an amount equal to the General Partner's share for that Accounting Period and pro rata in respect of Accounting Periods of more or less than one year.

8.2 Calculation of the General Partner's Share

The General Partner's Share of each Accounting Period shall be an amount equal to:

a. until the earlier of (i) the end of the Investment Period and (ii)

the date on which the Manager, General Partner or any Associate closes, acts as investment adviser or manages a Successor Fund, the sum of 2% per annum of the Total Commitment; and

b. thereafter, 2% per annum of the Acquisition Cost of Investments which have not been either:

i. distributed in specie; or

ii. realised and the proceeds distributed to investors.

For this purpose the winding up of any company in which an investment is held or the permanent write off or write down below Acquisition Cost of an Investment shall be treated as a realisation of the whole or part thereof and provided that where an Investment has only been partially realised the appropriate portion of the Acquisition Cost to be taken into account for this clause shall be the portion of the Acquisition Cost of the Investment equal to the proportion of the Investment that has been realised.

REDUCED by such part of any Transaction Fees, Underwriting Fees, Abort Fees and Other Fees that have been earned and retained by the General Partner, the Manager and any Associate of either of them during the previous Accounting Period pursuant to clause 4.9.2 up to a maximum amount that shall be no greater than an amount equal to the Abort Costs during the previous Accounting Period plus 50% of the excess (if any) of the Transaction Fees, Underwriting Fees and Other Fees for the previous Accounting Period over the Abort Costs for the previous Accounting Period (net of any VAT or similar tax related thereto).

8.3. Provisions relating to General Partner's Share

The following provisions shall apply in relation to the allocation of the General Partner's Share:

a. The General Partner's Share shall rank as a first charge on Net Income in any Accounting Period;

b. If Net Income in any Accounting Period shall exceed the share thereof to be allocated to the General Partner hereunder, the General Partner shall be entitled to elect, so far as practicable, which items of Net Income shall form the whole or a part of the share of Net Income allocated to the General Partner; and

c. If Net Income in any Accounting Period shall be less than the General Partner's Share, there shall be allocated to the General Partner as a first charge on all or against any surplus

of Capital Gains over Capital Losses in such Accounting Period an amount not exceeding the amount of the General Partner's Share which remains unsatisfied out of Net Income, provided that, instead of the order of priority set out in paragraph (a), (b) and (c) above, the General Partner shall be entitled to allocate the General Partner's Share against such items of Income or Capital Gains as it may select.

8.4 Deficiency in General Partner's Share

If Net Income and Capital Gains less Capital Losses in any Accounting Period shall be less than the General Partner's Share, any deficiency to the extent **not already drawn by the General Partner under clause 10.8** shall be paid to the General Partner as an interest free loan but such payment shall not extinguish the amount of the General Partner's Share outstanding which shall be carried forward to subsequent accounting periods: in the event that any part of the General Partner's Share then unpaid can subsequently be satisfied by an allocation of Net Income or Capital Gains to the General Partner such allocation shall be applied in the discharge of an equivalent amount of such loan; in no circumstances shall such loan be recoverable from the General Partner other than by an allocation of Net Income or Capital Gains in accordance with this paragraph.

10.8 Drawings by the General Partner

10.8.1. The General Partner shall be entitled to make drawings out of the Partnership's cash funds, on the First Closing Date in respect of the period from such First Closing Date up to the first quarter date thereafter and thereafter on, or on the first Business Day following, 31 March, 30 June, 30 September and 31 December in each year, on account of the General Partner's Share for the quarter commencing on that date. If at any time during or after a relevant Accounting Period it should be discovered that drawings made in respect of that relevant accounting Period are less or more than the amount that the General Partner is entitled to receive (whether by profit share pursuant to clause 8.1 or by interest-free loan pursuant to clause 8.4) pursuant to this Agreement then additional drawings shall be made to make good the shortfall or the excess shall promptly be repaid to the Partnership, as the case may be.

10.8.2. In no circumstances (except to the extent of any excess

drawings as stated in clause 10.8.1 above) shall any drawings made pursuant to this clause 10.8 be repayable by the General Partner other than by a set-off against allocations of Net Income and Capital Gains.

Additional information for the following three-stage example:

Year-end date:	December 31
First-closing date:	January 1, 2008
End of investment period:	December 31, 2009
(probably not very likely to end in just two years from the first closing, but used for the sake of this example)	
Total commitment:	£100,000,000
Transaction fees in 2010:	£300,000
Other fees in 2010:	£200,000
Abort costs in 2010:	£100,000
Investment details as of January 1, 2010 with no changes by December 31, 2010:	

Investment	Number of Shares disposed of
£80,000,000 (ABC)	£80,000,000
£10,000,000 (LMN)	1,000,000
£10,000,000 (XYZ)	£20,000,000

*Investment LMN went into administration on January 1, 2012.

Let's split the calculation in three stages, based on the different bases of calculation and adjustments used in the calculation.

Stage 1

Period from inception to December 31, 2010

- Management fee/GPS for the first period is calculated on a commitment-only basis with no adjustments/rebate due to the fact that the rebate is calculated based on the fees earned and abort costs incurred in the previous accounting period (that is, a year).
- Percentage management fee/GPS: 2 percent (as per clause 8.2.a of the LPA).
- Starting date: January 1, 2008 (first closing date as per clause 10.8.1 of the LPA).
- Ending Date: December 31, 2008.
- Basis of calculation: £100,000,000 (total commitment as per clause 8.2.a of the LPA).
- Number of days: 365.
- Management fee/GPS for the period*: $(£100,000,000 \times 2 \text{ percent} \times$

365 days/365 days) = £2,000,000.

*Note that the management fee/GPS is calculated in respect of accounting periods (usually defined in the definitions as a year), but the GP's entitlement to make management fee/GPS drawings is quarterly in advance on the first business day following the previous quarter-end (see clause 10.8.1 of the LPA), therefore the calculation in practice is done on a quarterly basis.

Stage 2

Period from January 1, 2009 to December 31, 2009

- Management fee/GPS is still calculated on the same basis – total commitment, but reduced by some transaction and other fees earned by the GP/manger in 2010 (most of the LPAs would provide for the adjustment to take place in the period, usually a year, following the period when they were incurred, but there would be LPA where that may not be the case, see the example in [Chapter 20](#)).
- Percentage GPS: 2 percent (as per clause 8.2.a of the LPA)
- Starting date: January 1, 2009.
- Ending date: December 31, 2009 (after that date the basis for calculation will change due to the end of the investment period).
- Basis of calculation: £100,000,000 (total commitment as per clause 8.2.a of the LPA).
- Number of days: 365.
- Management fee/GPS for the period before reduction for rebate/offset: ($£100,000,000 \times 2 \text{ percent} \times 365 \text{ days}/365 \text{ days}$) = £2,000,000.
- Management fee/GPS reduction/rebate/offset (calculated as per the last paragraph in clause 8.2 of the LPA). The calculation of the reduction/rebate/offset is spit below in two elements just for simplicity and better understanding:
 - a.The first element to reduce the GPS by is 100 percent of the transaction fees, underwriting fees, abort fees and other fees (as defined in the LPA) up to the maximum amount of the abort costs (if any). Note that, in reference to the LPA in this example, the fees must have been earned and retained by the general partner, the manager or any of their associates. Therefore, if any of the abovementioned fees have been earned by the partnership, no reduction of the GPS is applicable. In the example, the transaction fees amount to £300,000 and there are other fees amounting to £200,000 or a total of £500,000; however the calculation of this first element is limited to the amount of the abort costs incurred during the previous accounting period (as per most definitions again, this is the previous year, not quarter) which in this case is £100,000 or,

that is, the maximum amount that should be reduced under that provision. If there were no abort costs, then proceed to step b) below.

b. The second element to reduce the GPS by is 50 percent of the excess (if any) of the transaction fees, underwriting fees and other fees over the abort costs. The same period of calculation – previous accounting period – is applicable. In the example, the excess of the transaction and other fees over the abort costs is £400,000, so there is a need to calculate 50 percent of £400,000, which is £200,000. The reason for the 50 percent rebate/offset is to discourage the GP from participating in such activities and keep their focus on managing the fund instead.

The total rebate/offset from a) and b) is £300,000.

- Management fee/PPS for the period after reduction/rebate/offset: £2,000,000 minus £300,000 = £1,700,000.

Stage 3

Period from January 1, 2012 to December 31, 2012

- Management fee/PPS is calculated on a new basis – acquisition costs of unrealised and undistributed investments) after the end of the investment period adjusted for any permanent write-offs/write-downs, that is, on the actively invested capital.
- Percentage PPS: 2 percent (as per clause 8.2.b of the LPA).
- Starting date: January 1, 2010 (after the end of the investment period on December 31, 2009)
- Ending date: December 31, 2010.
- Basis of calculation: the new basis of calculation of the management fee/GPS after the end of the investment period, pursuant to clause 8.2.b of the LPA, is the acquisition cost of unrealised and undistributed investments adjusted for any permanent writeoffs/write-downs (that is, on actively invested capital).
- Investment ABC fully realised on January 1, 2010, therefore, it is not included in the basis of calculation.
- Investment LMN is in administration on January 1, 2010, therefore, it needs to be permanently written off and for the purposes of management fee/GPS calculation treated as realised.
- Investment XYZ is partially realised, therefore, there is a need to work out the acquisition costs of the unrealised investment which is £60,000,000 – (£60,000,000 total acquisition costs x 25,000,000 shares disposed of /50,000,000 shares acquired) = £30,000,000.
- Number of days: 365.

- Management fee/GPS for the period: $(£30,000,000 \times 2 \text{ percent} \times 365 \text{ days}/365 \text{ days}) = £600,000$.

The situation at Stage 3 would have been more complicated if Investment LMN had gone into administration or if the disposals of Investments ABC and XYZ have taken place during the period in which case you should have equalised the calculation and made adjustments ideally in each quarter.

There is another insightful example in **Chapter 20**, based on a slightly different LPA scenario, namely that the rebate is calculated based on the current year's fees and abort costs, but the above scenario, in my experience, is the more common one.

Accounting treatment

For accounting purposes, under most recognised accounting frameworks – IFRS, UK GAAP and US GAAP – the management fee is treated as any other fee and therefore charged to profit & loss.

Management fee

Let's continue with the numbers from the example of the calculation above in which the management fee for the first period (year 2008) was £2,000,000. Since the management fee is usually paid quarterly in advance, typically due on the first day of the quarter, the amount for the first quarter is $£2,000,000 \times 90 \text{ days} / 365 = £493,150$ if calculated on a daily basis or a flat one-quarter of the annual charge of £2,000,000 (that is, £500,000) depending on what your LPA stipulates (if detailed enough).

1.If paid on the due date (following this example on January 1, 2008), the entry would be:

~~500,000~~ Management fee (expense)
~~500,000~~ Cash

2.If not paid on the due date:

a. To reflect the liability and incur the expense on the due date:

~~500,000~~ Management fee (expense)
~~500,000~~ Due to GP (creditors)

b. When paid:
~~500,000~~ to GP (creditors)
~~500,000~~ cash

3.If prepaid:

a. When paid in advance:
~~500,000~~ management fee prepaid (prepayments)
~~500,000~~ cash

b. To reverse out the prepayment – when the management fee falls due:
~~500,000~~ management fee (expense)
~~500,000~~ management fee prepaid (prepayments)

Priority profit share – current accounting practices

This is an area of mixed practice on the accounting treatment of the PPS. Currently there are generally two approaches, although I have seen funds where the PPS is still accounted for as management fee (but I will ignore that approach as it is usually incorrect). What is common between these two approaches is that the PPS is not treated as a fee and charged to profit & loss like the management fee. Both treatments try to mimic the LPA, but in slightly different ways by focusing on different provisions of the LPA.

How does the convoluted legal jargon translate into accounting language? Clause 8.1 stipulates that the GPS (as explained earlier in the chapter, GPS and PPS are used interchangeably throughout this chapter and the rest of the book) is a guaranteed profit share and ranks as a first charge of net income and capital gains for each accounting period, that is, a year. What that means is that later in the life of the fund when it starts generating profits/gains, in each accounting period they are first allocated to the general partner and offset against the PPS (reflected in the overdrawn GP's partner's account).

With reference to clause 10.8, during the accounting period, the GP makes drawings out of the partnership's cash funds on certain dates (typically on a quarterly basis in advance starting on the first closing date and subsequently on the first date of each quarter) on account of the PPS. The drawings need to be checked against the entitlement and if found that they are more or less than the entitlement, then an

adjustment needs to be made and either additional funds need to be paid to the GP or the GP needs to pay back to the fund the amount of the overpayment as the case may be. At the year-end (although that is usually done quarterly), the PPS needs to be compared to the financial result and if any profit and/or gain, it needs to be allocated/offset against that profit/gain. If done quarterly, then annual (if not quarterly) equalisation may need to be done.

The order of priority of allocation is set out in clause 8.3 – the GPS is first allocated to/offset against the net income pursuant to clause 8.3.a (please note the definition of net income which doesn't include the capital gains). In the same clause, there are provisions for different case scenarios – the first one in clause 8.3.b is when the net income in any accounting period exceeds the GPS, in which case the general partner is entitled to elect which items of net income to form the net income allocated to and offset against the GPS.

Another scenario described in clause 8.3.c is when the net income in any accounting period is less than the GPS, in which case after exhausting the net income, the GPS is offset against any surplus of capital gains over capital losses.

However, despite the order of priority described in clause 8.3.b and 8.3.c, the general partner is usually allowed to override that order and allocate the GPS against such items of net income or capital gains as it may deem appropriate, that is, to make an election. An interesting aspect of the election is that the GP may cherry-pick certain elements of income and if tax-planned properly that can improve its tax position which, however, may result in a conflict of interests between the GP and LPs, but I will leave this aspect to tax advisers.

Furthermore, clause 8.4 basically elaborates on the situation in clause 8.3.c when the GPS exceeds the sum of the net income and capital gains in any accounting period and how to treat the deficiency that has not already been drawn by the general partner, namely as an interest-free loan.

Note that in reference to clause 10.8.2, although the drawings made in the case of deficiency described in clause 8.2.1 are referred to as an interest-free loan, that 'loan' is not subject to repayment, therefore even in the worst-case scenario when the fund is wound up earlier before it starts generating profits, the interest-free loan will not be repaid by a regular way of repayment; the only way to settle the loan is by offsetting it against future profits and/or gains generated by the fund. Clause 8.4 confirms that by expressly stating that: "In no

circumstances shall such loan be recoverable from the General Partner other than by an allocation of Net Income or Capital Gain.”

The concept about the drawings stems from the corporate practice most of the owners of small limited companies resort to way too often, namely to draw funds from the company during the year and then offset them against the profits to be distributed in the form of dividend at the end of the year when it is clear what the financial result/profit is. Now that some light has been shed to the legal concept, let's go back to the two most popular accounting approaches:

First approach – treated as a loan

In some funds, in the early stages of the fund lifecycle, the GPS is treated as a loan to the GP (receivable from the GP) on the balance sheet, as it is described in clause 8.4 of the above LPA excerpt, until the fund has sufficient profits to allocate GPS/PPS to the GP. When the fund has sufficient profits/gains, those profits/gains are allocated to the GP and the loan to the GP is extinguished (receivable from the GP offset) against them. There is profit & loss movement.

Second approach – treated as an allocation of profits

In other funds, unlike the first approach, at the early stages of the fund when there are insufficient profits/gains to offset it, the PPS is presented in the partners' accounts/statement as 'GP drawings' and when there are sufficient profits, they are offset against these GP drawings, again presented better and in more detail in the partners' accounts/statement. Similar to the first approach, there is no profit & loss movement, it is only presented as an allocation of profit.

This is also shown as an allocation of profits on the face of the profit & loss account (at the bottom where the profit/loss is allocated to the different types of partners – including LPs and GP) and even if the profits are insufficient, full allocation is shown on the face of the profit & loss.

Preferred approach

The preferred approach is the second approach – that is, to treat it as an allocation to profit & loss. The argument is that it is an accrual of a known commitment, the loan is not subject to repayment, therefore is an advance similar to an accrual.

In the GP books, most often GPs show PPS as income, instead as a guaranteed share of the fund's profits, but that would generally defeat the purpose of the whole legal and tax structuring concept and the tax authorities may feel tempted to follow the accounting treatment,

although tax and accounting should be regarded separately. There is no difference between principles in either UK GAAP or IFRS. To make it clear, let's use a simple example to see what the entries and the impact on the financial statements would be over the life of the fund by following the preferred approach of accounting for GPS/PPS.

Step 1

Investors contribute cash into the fund in the form of loan contributions – for example, £110, out of which £100 for an investment and £10 for GPS.

Dr Cash

Cr Loan contributions

Balance sheet (before)

Cash	-
	-

Loan account	-
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Total	-
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Impact on the financial statements – balance sheet

Balance sheet (after)

Cash	110
	110

Loan account	110
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Total	110
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Step 2

The general partner draws cash in the form of GP drawings – £10, an advance on entitlement to a profit share, and assuming there are no profits at this stage it is taken as an interest-free loan (remember that this is a special kind of loan or rather a cash advance), in other words it would appear in the partners' accounts as if the GP has an overdrawn partner's account.

Impact of Step 1 on the capital account



Figure 12.1: Statement of changes in partners' accounts (capital account) – step 1

Investment	Opening balance	Contributions	GP drawing	Net income/ (expenditure)	Realised gains/(losses)	Distributions	Closing balance
Limited partners							
Loan account	-	110	-	-	-	-	110
GP drawings	-	-	-	-	-	-	-
Income account	-	-	-	-	-	-	-
Capital account	-	-	-	-	-	-	-
Sub total	-	110	-	-	-	-	110
General partners							
Loan account	-	-	-	-	-	-	-
GP drawings	-	-	-	-	-	-	-
Income account	-	-	-	-	-	-	-
Capital account	-	-	-	-	-	-	-
Sub total	-	-	-	-	-	-	-
Total							
Loan account	-	110	-	-	-	-	110
GP drawings	-	-	-	-	-	-	-
Income account	-	-	-	-	-	-	-
Capital account	-	-	-	-	-	-	-
Sub total	-	110	-	-	-	-	110

Impact on the financial statements – balance sheet

Dr GP drawings	10
Cr Cash	10

Balance sheet (before)

Cash	110
Total	110

Loan account	110
GP drawings	0
Total	110

Balance sheet (after)

Cash	100
	100
Loan account	100
GP drawings	(10)
Total	110

Impact of Step 2 on the capital account

Figure 12.2: Statement of changes in partners' accounts (capital account) – Step 2

Investment	Opening balance	Contributions	GP drawing	Net income/ (expenditure)	Realised gains/(losses)	Distributions	Closing balance
Limited partners:							
Loan account	110	-	-	-	-	-	110
GP drawings	-	-	-	-	-	-	-
Income account	-	-	-	-	-	-	-
Capital account	-	-	-	-	-	-	-
Sub total	110	-	-	-	-	-	110
General partners							
Loan account	-	-	-	-	-	-	-
GP drawings	-	-	(10)	-	-	-	(10)
Income account	-	-	-	-	-	-	-
Capital account	-	-	-	-	-	-	-
Sub total	-	-	(10)	-	-	-	(10)
Total							
Loan account	110	-	-	-	-	-	110
GP drawings	-	-	(10)	-	-	-	(10)
Income account	-	-	-	-	-	-	-
Capital account	-	-	-	-	-	-	-
Sub total	110	-	(10)	-	-	-	10

Step 3

Dr Investments	100
Cr Cash	100

Impact on the financial statements – balance sheet
Fund makes an investment for £100.

Balance sheet (before)

Investment	-
Cash	100
Total	100

Loan account	110
GP drawings	(10)
Total	100

Balance sheet (after)

Investment	100
Cash	-
	100

Loan account	110
GP drawings	(10)
Total	100

No changes to the partners' account (capital account).

Step 4

The fund disposes of the investment and as a result makes gains and allocates them to the LPs and the GP – £150 proceeds from disposal of investment. Priority slice of the profits (£10) goes to the GP and the rest (£40) goes to the LPs.

Dr Cash	150
Cr Investments	100
Capital gains	50

Impact on the financial statements – balance sheet

Balance sheet (before)

Investment	100
Cash	-

	100
Loan account	110
GP drawings	(10)
Capital gains	-
Total	100
Balance sheet (after)	
Investment	-
Cash	150
	150
Loan account	110
GP drawings	(10)
Capital gains	50
Total	150
Impact on the financial statements – profit & loss account/income statement	
Income	-
Expenses	(-)
Gain on disposal	50
Net result for the period	50
Impact of Step 4 on the capital account	

Figure 12.3: **Statement of changes in partners' accounts (capital account) – Step 4**

Investment	Opening balance	Contributions	GP drawing	Net income/ (expenditure)	Realised gains/ (losses)	Distributions	Closing balance
Limited partners							
Loan account	110	-	-	-	-	-	110
GP drawings	-	-	-	-	-	-	-
Income account	-	-	-	-	-	-	-
Capital account	-	-	-	-	40	-	40
Sub total	110	-	-	-	40	-	150
General partners							
Loan account	-	-	-	-	-	-	-
GP drawings	(10)	-	-	-	-	-	(10)
Income account	-	-	-	-	-	-	-
Capital account	-	-	-	-	10	-	10
Sub total	(10)	-	-	-	10	-	-
Total							
Loan account	110	-	-	-	-	-	110
GP drawings	(10)	-	-	-	-	-	(10)
Income account	-	-	-	-	-	-	-
Capital account	-	-	-	-	50	-	50
Sub total	100	-	-	-	50	-	150

Allocated as follows:

Limited partner	40
General partner	10
Total	50

This assumes the GP is only entitled to £10 PPS per year (as this is before the second period the GP only receives £10). If it has taken longer to make profit, the GP might be entitled to a bigger slice, for several years' PPS.

Within the partners' accounts schedule, the GP receives £10 of the £50 profit and the LPs receive £40. The fund does not want to keep spare cash so will look to make a distribution.

As the GP has £10 credit in its capital-gains account and £10 debit in

its drawings account, this allows for an offset of those amounts and it is all fair and square.

The GP does not need any cash to be distributed out of these proceeds, as it already took the £10 cash right at the start.

Step 5

So, there is £150 spare cash to give to LPs. They would get: a) £100 distributed as a return of cost of their investment; b) once they have their contribution returned to them, the remainder of the payment is a distribution of realised gains of £40 from the gain that was allocated to them; and c) £10 distributed as a return of the money they funded for GP share.

Dr loan distribution	110
Capital distribution	40
Cr cash	150

Impact on the financial statements – balance sheet

Balance sheet (before)

Investment	-
Cash	150
	150

Loan account	110
GP drawings	(10)
Capital-gains account	50
Total	150

Balance sheet (after)

Investment	-
Cash	-
	-

Loan account	-
GP drawings	(10)
Capital-gains account	10
Total	-

Impact of Step 5 on the capital account

Figure 12.4: Statement of changes in partners' accounts (capital account) – Step 5

Investment	Opening balance	Contributions	GP drawing	Net income/ (expenditure)	Realised gains/(losses)	Distributions	Closing balance
Limited partners							
Loan account	110	-	-	-	-	(110)	-
GP drawings	-	-	-	-	-	-	-
Income account	-	-	-	-	-	-	-
Capital account	40	-	-	-	-	(40)	-
Sub total	150	-	-	-	-	(150)	-
General partners							
Loan account	-	-	-	-	-	-	-
GP drawings	(10)	-	-	-	-	-	(10)
Income account	-	-	-	-	-	-	-
Capital account	10	-	-	-	-	-	10
Sub total	-	-	-	-	-	-	-
Total							
Loan account	110	-	-	-	-	(110)	-
GP drawings	(10)	-	-	-	-	-	(10)
Income account	-	-	-	-	-	-	-
Capital account	50	-	-	-	-	(40)	10
Sub total	150	-	-	-	-	(150)	110

Step 6

The fund distributes gains to the GP (not in cash, but by offsetting the GP loan) – £10 allocation of profit to GP. The only balances remaining in the partners' accounts after the distribution to LPs in Step 5 are the GP's realised gain and the deficit on its account from when it took the advance on GPS entitlement in the form of the interest-free loan at the start. These would then be offset, that is, by distribution of GP's profits settles his loan.

Dr capital gains distribution	10
Cr GP drawings	10

Impact on the financial statements – balance sheet

Balance sheet (before)

Investment	-
Cash	-
	-

Loan account	-
GP drawings	(10)
Capital account	10
Total	-

Balance sheet (after)

Investment	-
Cash	-
	-

Loan account	-
GP drawings	-
Capital account	-
Total	-

Impact of Step 6 on the capital account

Figure 12.5: **Statement of changes in partners' accounts (capital account) – Step 6**

Investment	Opening balance	Contributions	GP drawing	Net income/ (expenditure)	Realised gains/(losses)	Distributions	Closing balance
Limited partners							
Loan account	-	-	-	-	-	-	-
GP drawings	-	-	-	-	-	-	-
Income account	-	-	-	-	-	-	-
Capital account	-	-	-	-	-	-	-
Sub total	-	-	-	-	-	-	-
General partners							
Loan account	-	-	-	-	-	-	-
GP drawings	(10)	-	-	-	-	10	-
Income account	-	-	-	-	-	-	-
Capital account	10	-	-	-	-	(10)	-
Sub total	-	-	-	-	-	-	-
Total							
Loan account	-	-	-	-	-	-	-
GP drawings	(10)	-	-	-	-	10	-
Income account	-	-	-	-	-	-	-
Capital account	10	-	-	-	-	(10)	-
Sub total	-	-	-	-	-	-	-

Although this is generally the preferred method, you will find different variations of this accounting treatment in different funds. So, you probably do not need to change your method after you have read this book, but if you are still charging PPS to profit & loss, and there is no good reason for that, I would say this is a fundamental error and you should seriously consider changing your method.

Summary

In this chapter I have discussed management fees compared with the PPS, which is a UK management fee structured differently for tax-efficiency whose difference predicates the different accounting treatment and presentation in the financial statements. I have also discussed and provided an example of a calculation of a management fee, generally the same for PPS, with the calculation of rebates/offsets

for fees earned by the manager and abort costs incurred. The next chapter will focus on the next process in the fund lifecycle: drawdowns. Now that the difference between the management fee and the PPS has been clarified, the following chapter will focus on the next process in the fund lifecycle: drawdowns.

13

Distributions

By Mariya Stefanova

This chapter discusses:

- What is a distribution?
- Where are the rules of the distributions stipulated?
- What are the different types of distributions?
- Timing of the distributions and distribution date
- Limitations on distributions
- Distribution notices and content of distribution notices
- ILPA Private Equity Principles Version 2.0 and Standardised Reporting Templates
- Application of cash
- Distribution calculation (calculation of each partner's share of the distribution)
- Net (simultaneous) distributions
- Accounting implications and impact on the financial statements
- The fund of funds perspective on distributions
- Distributions in specie
- Distribution processes
- Final verification of distributions and checking for carried interest clawbacks
- Reinvestment (recycling) of distributions – temporary/redrawable and permanent distributions

What is a distribution?

Distribution is a process of returning the funds originally drawn down (plus profit/gain) from investors and subsequently used to invest into portfolio companies after the portfolio companies have been divested or investment income has been received. The source of distributions is either the proceeds from the disposal of investments or income from those investments (for example dividends and interest).

Where are the rules of the distributions stipulated?

Similar to the drawdowns discussed in [Chapter 7](#), all the rules governing distributions are stipulated in the limited partnership agreement (LPA). Distributions are usually subject to a separate section in the LPA, which is likely to be called 'Distributions of income and capital proceeds' or simply 'Distribution of proceeds', but very often they are in the same section as the allocations (of income and capital gains/losses) and partners' accounts (what different partners' accounts need to be maintained – for example, capital contributions, loan, income and capital accounts). For UK funds, general partner (GP) drawings (when the management fee is structured as a priority profit share (PPS)) may also be part of the distributions section, which makes sense considering their nature (for more details see [Chapter 12](#)).

What are the different types of distributions?

There are different types of distributions, although very often you will see some or all of them as part of or elements of one distribution. These different types comprise the following:

- Return/repayment of loan (or return of capital contributions, in the US, Cayman and other jurisdiction funds where there is no split into capital contributions and loan contributions).
- Income distribution.
- Capital distribution.

Return/repayment of loan/capital contributions, as the name unambiguously indicates, is a distribution or part of a distribution up to the amount of the loan (or the capital contributions for funds in the US, Cayman and other jurisdictions where there is no split between capital contributions and loan contributions); for more information see [Chapters 2](#) and [Chapter 7](#), in respect of a specific investment, previously drawn down from the investors. Loan/capital contributions drawn down to fund partnership expenses or management fee may also be repaid as return/repayment of loan/capital contributions, but these are usually redrawable.

Income distribution is a type or that part of a distribution that is attributable to income proceeds, for example, dividends, interest on loan notes or bonds (or rental income for property funds).

Capital distribution is a type or that part of a distribution that is attributable to capital gains, related to a specific investment, on

realisation of that investment.

Timing of the distributions

For income distributions, usually, but not necessarily, the LPA allows some more time compared to capital distributions (for example, 30 days from the quarter-end date in which it has been received) or sometimes the LPA may stipulate 'as soon as practicable' or 'as the GP decides in its reasonable discretion' – very often the GP exercises that discretion. If the amount is not significant it would probably not run a separate distribution if there are no other proceeds of more significant amounts to be distributed, particularly if that would involve incurring extra costs (for example, if the distributions are done externally by a fund administrator). It is in the GP's best interest though to make the distribution as soon as possible instead of keeping the money in the bank account, as an early date would boost the IRRs, which are time-sensitive, so the GP would not unnecessarily hold the funds.

For capital distributions the timing is usually referred to 'as soon as practicable after the relevant amount becomes available for distribution' (or similar terms) as they are of more significant amounts and the funds need to be returned to the investors 'as soon as practicable', plus from the GP's perspective the impact on the IRRs would be greater.

Distribution date

The distribution date (except in the cases of distributions *in specie* where different rules apply) is usually the expected value date of the distribution payment to the investors, which is typically different from the date of the distribution notices that goes out to the investors to pre-notify them (and usually allows them some time to revert to the GP in confirming that the bank details on the distribution notice are accurate) that soon they should be receiving money from the fund in the form of a distribution. Similar to drawdowns, the date is important because it is used for the purpose of the IRR calculation, but unlike for distributions, in the majority of cases (except where the distribution payments are retained for some reason, for example an limited partner (LP) may have not confirmed their bank details as they have been asked) it will coincide with the actual cash flow.

Limitations on distributions

The LPA usually provides for the financial protection of the fund and would allow the GP to exercise discretion about when and if (at all) the distribution should be made. Therefore, if there is insufficient cash or if the distribution would leave the partnership with insufficient funds to meet any future contemplated obligations or contingencies, the GP would have the discretion to withhold the distribution until such time or distribute as much money as reasonable. Usually in the 'application of cash' clause in the LPA, the GP would be given discretion in determining the amount of cash available for distribution to retain income and/or capital proceeds and use them to pay expenses and liabilities of the partnership.

Distribution notices

Similar to drawdowns, and in addition to the LPA which stipulates the rules of the distributions, another important document in which the distribution materialises is the distribution notice.

What is a distribution notice? Similar to the drawdown notice explained in [Chapter 7](#), a distribution notice is a formal letter served to the investors with the aim of pre-notifying them that they should expect on a certain date, specified in the distribution notice, to receive a certain amount distributed to them by the fund's GP. Usually the distribution notices are sent out to the investors in advance (although sometimes less notice is given compared to drawdowns), allowing them enough time to check their bank details where the funds are to be transferred to and confirm their accuracy. The letter usually specifies, although not always with the same level of detail, what the source of the distribution is, and it may provide some additional information, particularly if the source is a disposal of an investment.

Content of the distribution notice

Although the content of the distribution notice may not be stipulated expressly in the LPA, templates of drawdown and distribution notices are often appended to the LPA, it will broadly mimic the content of a drawdown notice as described in detail in [Chapter 7](#).

Good distribution notices are detailed, so that they provide investors with as much information as possible and would broadly have the following structure, which is basically the same as the drawdown notice's structure (for more detail see [Chapter 7](#)):

- Cover letter (optional).
- The actual distribution notice.
- Schedule to distribution notice.
- Confirmation that the bank details on the distribution notice are correct that needs to be returned to the GP or its administrator (optional, but a good practice).

In addition, and/or different from the requisites of the drawdown notice, are the following pieces of information:

- Bank details of the relevant investor (not the fund/GP as for the drawdown notices) where the funds are to be transferred to by the GP (it is a good practice, and that will cover your back, to ask the investor to confirm the details – allow investors a reasonable amount of time to do so and state that if they do not reply with new bank details that the current details will be considered to be correct or in more extreme cases that the distribution amount will not be paid out until the bank details are confirmed).
- The source of the distribution (for example, related to disposal of investment X or from dividends and interest on loan notes from investment Y and Z).
- The breakdown of return of loan contributions (for UK funds)/capital contributions (for US or similar funds) (which is the cost – the amount originally invested by the LP), capital distribution and income distribution (if any).
- Mention if the different elements of the distribution are redrawable/available for redrawing/re-advancement (or if they are permanent or temporary, although often only the temporary/redrawable amounts are mentioned expressly).
- Date when the funds are to be transferred to the investor's bank account (value date).
- Date by which the investor needs to confirm the accuracy of its bank details stated on the distribution notice.
- If a net distribution, the amounts and other details of the drawdown to be netted off against the distribution.
- Total distributions to date.
- Total drawdowns to date.

Information similar to the information in the drawdown notices as explained in **Chapter 7**:

- Reference to the LPA.
- Reference to the commitment of the investor the notice is intended for.
- Total amount distributed.

- Portion of the distribution for the investor the notice is intended for.
- Issue date of the distribution notice.
- Cumulative contributions prior to this distribution (absolute amount and/or percentage).
- Remaining commitment prior to this distribution (absolute amount and/or percentage).
- Cumulative contributions after this distribution (absolute amount and/or percentage).
- Remaining commitment after this distribution (in absolute amount and/or percentage).
- Other useful information as deemed by the GP/investors.

A sample drawdown notice is provided in [Appendix II](#).

ILPA Private Equity Principles Version 2.0 and Standardised Reporting Templates

As discussed in [Chapter 7](#), it is worth mentioning that Institutional Limited Partners Association (ILPA) has issued *Standardised Reporting Templates*, with Version 2.0 of its Private Equity Principles, which were released in January 2011 (in its brief format) followed, in October 2011, by comprehensive Capital Call & Distribution Notice Best Practice guidelines with detailed practical guidelines, samples, glossary, checklist, templates of drawdown and distribution notices and other useful information.

Time will tell whether GPs will follow suit and adopt the templates, but I have recently seen providers of specialist private equity software platforms that are already implementing these formats as a recommended best practice.

Application of cash

Although application of cash – also called waterfall – refers to distributions, this subject will be discussed in detail in [Chapter 14](#) in the general discussion of carried interest.

Distribution calculation

Similar to drawdowns, when it comes to calculation the LPA usually refers to it for each investor and in terms of allocation of the distribution between investors, most often, the total amount to be distributed is allocated proportionally (in respect of each investor's commitment)

between the investors.

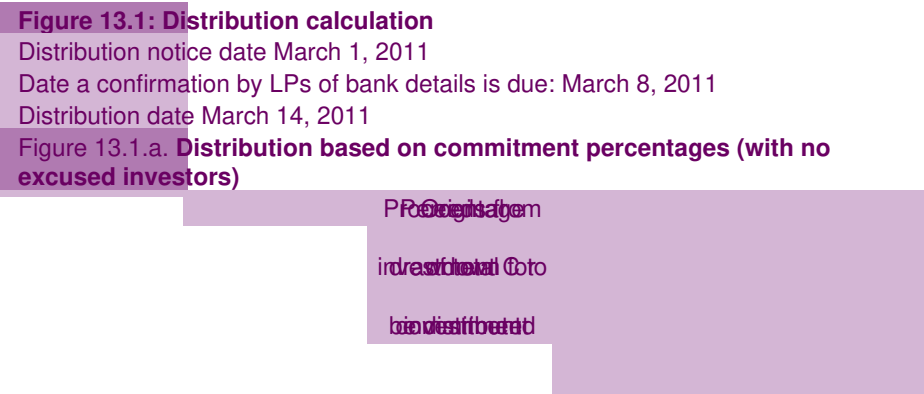
There are funds, however, where allocation rules are much more complicated and usually the drawdowns would predicate the distributions. In other words, to make it fair and square to the investors, the distribution would broadly reflect the way the loan contributions (or capital contributions for US and similar funds with no split of capital contributions and loan contributions) has originally been drawn down.

For example, if there is an excused investor that has not contributed money to fund certain investment, then of course on disposal of that investment that excused investor would be excluded from the distribution and usually sharing percentages with respect to such portfolio investment are used.

Again, the rule of thumb is to read your LPA very carefully to find out what these rules are and particularly the section on the application of cash should contain most of the answers to your questions. Do not forget that GP and founder partner (FP) can have different capacities – as GP and FP/carried interest partner (CIP) and as LPs as explained in [Chapter 7](#) and therefore receive distributions in these (different) capacities.

In addition, do not forget about the specific complications typical to your fund as these need to be figured out way before the time the distributions are made or are received.

A sample distribution calculation is provided in [Figure 13.1](#) to illustrate the most common situation – proportional allocation in respect of commitments or bycommitment (and usually closing date) allocation rule ([Figure 13.1.a](#)), compared to another relatively common allocation rule using sharing percentages whereby the sharing percentages are specific to each deal and are based on the original drawdown for each investment.



~~100%~~ #1
~~100%~~ #2
~~100%~~ #3
~~100%~~ #4
~~100%~~ #5
~~60%~~ investor
~~50%~~

Distributions when at carry point

For whole-of-fund carried interest models, later in the life of the fund when carried interest becomes imminent, that is, closer to the point when the loan (for UK funds) or capital (for US funds) account will have been repaid (and past hurdle), if not earlier when the net asset value (NAV) amount is sufficient to repay loan (for UK funds) or capital (for US funds) contribution plus hurdle, you need to start planning for modelling the carried interest. This is somewhere between these two trigger points as it will be part of your distribution calculation – basically how much money would go to LPs, how much would go to CIP – GP or FP – and how much would go to any other classes of partners (if any). This calculation is paramount to your distribution and you have absolutely no room to get this wrong. For more information on carried interest read chapter [Chapter 14](#) very carefully.

For deal-by-deal carried interest models, the carry calculation needs to be factored in with each distribution returning proceeds from disposal of investments, so you need to plan the design of the carried interest model at a very early stage in preparation for the disposal of your first investment and distribution of the disposal proceeds, respectively. For more detail on carried interest see [Chapter 14](#).

Net (simultaneous) distributions

Similar to drawdowns, where distributions are netted off against drawdowns, for net distributions it is the other way round, that is, drawdowns will be netted off against distributions when the cash to be distributed is more than the amount required for drawdown. In these cases a net distribution notice is served to the investors. However, in the net distribution notice the amounts of the drawdown and the distribution need to be stated separately. In the fund accounts the drawdown and the distribution elements should not be offset – the drawdown and distribution amounts should be accounted for

separately in the appropriate manner as described in this chapter and in [Chapter 7](#), respectively.

Figure 13.1.b: Distribution based on sharing percentages with excused investors (following the example in Figure 7.2)

	Commitment	Percentage of total commitment	Commitment drawdown percentage	Remaining commitment	Percentage based on remaining commitment used for the original drawdown of investment C	Original drawdown for investment C based on remaining commitment	Drawdown by participant's expenses	Drawdown for management fee	Total drawdown	Sharing percentages for investment C	Final distribution based on sharing percentages
Investor #1	100	19.80%	20	80	18.43%	18.43	1.98	2.00	22	18.43%	27.65
Investor #2	100	19.80%	20	80	18.43%	18.43	1.98	2.00	22	18.43%	27.65
Investor #3 (Excused Investor**)	100	19.80%	0	100	20.73%	20.73	1.98	2.00	25	20.73%	31.70
Investor #4 (Excused Investor**)	100	19.80%	0	100	23.04%	23.04	1.98	2.00	26	23.04%	34.55
Investor #5	100	19.80%	20	80	18.43%	18.43	1.98	2.00	22	18.43%	27.65
Gifted Investor	4	1.00%	1	4	0.94%	0.94	0.10	0.00	1	0.94%	1.40
Total	505	100.00%	71	434	100.00%	100.00	10	10	120	100.00%	150.00

* Investor #3 is an excused investor and does not wish to participate in alcohol and cigarettes deals (following from the example in Figure 7.2 Drawdown Calculation)

** Investor #4 is an excused investor and does not wish to participate in alcohol, cigarettes and gambling deals (following from the example in Figure 7.2 Drawdown Calculation)

Accounting implications and impact on the financial statements

Accounting for distributions is no more complicated than accounting for drawdowns, but you need to choose the exact method that you will be using. You need to consider the partners' accounts structure as stipulated in the LPA, and the reporting and/or presentational preferences (if there is any room for preferences) and/or requirements, whether by the specific GAAP that you are applying, which is relatively unlikely, or by the investors, which is slightly more likely.

In terms of impact on the financial statements, a drawdown will have an impact on the following:

- The balance sheet.
- The income statement (profit & loss account), which is an impact that the drawdowns did not have (strictly speaking this is not really the distribution, but rather the proceeds/recognition of income/gains, that impacts the income statement).
- The capital account/partners' account through the loan

contributions accounts for UK funds (or capital contributions account for US or similar funds where there is no split into capital and loan contributions).

- Distribution payable.
- Cash.

The following section contains sample journals to reflect the impact of a distribution.

When proceeds are received

Some LPAs stipulate that you should keep separate income and capital accounts (within the partners' account) and that you credit income and capital proceeds to these income and capital accounts, respectively.

Other LPAs state that you need to keep only one merged account (in some LPAs this is called the current account) and you charge both income and capital proceeds to that merged (current) account. In terms of general ledger (GL) accounts, which is not the same as partners' accounts in the LPA, although you may want to mirror the structure of the partners' account in the accounting, you would probably prefer or be required to keep separate GL accounts and an account for income and capital proceeds separately.

However, you may present them on the balance sheet in one merged item/account, although on your profit & loss account you would have to present them separately. Considering the structure of the partners' account different auditors express different opinions. Some auditors think there is no accounting basis to keep a separate capital (gains) account and a net income (profit & loss) account regardless of what the LPA stipulates; you will find that some auditors will have strong arguments in favour of this approach. Other auditors would disagree and would advise you to stick to the provisions set out in the LPA, so make sure that you agree the partners' account structure with the auditors from the outset.

If you want to present it in one item on the face of the balance sheet (and the capital account statement/note) and if it is not specifically termed in the LPA, you can also call it 'income & capital account' or simply 'income account' or whatever you think best describes the nature of the account. This allows you to present both income and capital proceeds in the merged item/account.

To continue with the example from [Chapter 7](#), where a total of £10.8

million has been drawn down, or £10 million for investment ABC Telecoms, £500,000 for management fees (assume that this is the only amount drawn down during the period between the first drawdown and when the distribution takes place), capital contributions of £1,000 and establishment costs of £300,000 (assume there were no fund expenses drawn down), assume that the investment is sold for £15 million, that is, a £5 million capital gains realised from the disposal of that investment out of which £1 million is a dividend on realisation.¹

Journal 1:

Dr Cash	15,000
Cr Investment – with the amount of the cost of the investment	15,000
Capital account (if kept separately) – with the capital gain	4,000
Income account – with the income element (assuming that our accounting policy is to present the dividend on realisation as investment income)	1,000

The impact on the balance sheet is reflected below:

Balance sheet (Before Journal 1)

(see Chapter 7)

Investments	10,000,000
Cash	1,000
	10,000,100
Capital-contributions account	1,000
Loan-contributions account	10,800,000
Income account	(800,000)
Capital account	0
	10,001,000

Balance sheet (After Journal 1)

Investments	0
Cash	15,001,000
	15,001,000
Capital-contributions account	
Loan-contributions account	10,800,000
Income account	200,000
Capital account	4,000,000
	15,001,000

When proceeds are distributed to investors

You may account for the distribution of proceeds using two different methods depending on the structure of the partners' accounts in the LPA as explained above and/or your and your investors' presentational preferences. Whereas there is almost always a clause about variation of these accounts, in some LPAs it is left to GP discretion while in others it requires an auditors' or the advisory committee's consent.

However, in most cases the GP will probably be able to take advantage of the clause, and therefore, modify the structure, the use and even the names of the partners' accounts, if deemed appropriate.

The first method is to debit all the proceeds distributed to investors to a separate distributions account, but ideally you should have an extra analysis level to distinguish between the different elements of the distribution – distribution with regards to cost of investment, income distribution and capital (gains) distribution, thus, assuming that you will mimic that structure in the bottom part of your balance sheet.

Journal 2A:

~~£5,000,000~~ions*
~~£5,000,000~~

*Ideally with an extra analysis by type of distribution – return-of-loan distribution/cost (£10 million), capital (gains) distribution (£4 million) and income distribution (£1 million).

Advantages

It would be easy for you (and the users of the financial statements), by glimpsing at the balance (or the trial balance) to see the cumulative amount (inception to date) of contributions, the cumulative amount of distributions regardless of the nature of the different distributions, as well as the cumulative amount of the capital gains.

Disadvantages

What you would not be able to see straight away is the different elements/types of distributions – how much of the total distributions are capital-gains distributions, how much the income distributions are and how much is the return-of-loan/cost distributions. Again, if you keep an extra analysis level by type of distribution and if your capital account/partners' account is properly designed as part of the financial statements that should not be a problem (for more information see [Chapter 15](#)).

Alternatively, you may not keep a separate 'distribution account', which you present on the face of the balance sheet (the bottom section), but only a net-loan account, in which case you can debit an amount up to the amount of the cost of the investment to the loan account and capital (gains) element debit to the capital account and the income element (if any) to the income account.

Journal 2B:

Dr Loan account*	10,000,000
Income account**	1,000,000
Capital (gains) account***	4,000,000
Cr Cash	15,000,000

* With the amount of the cost of the investment.

** If any element of income from that investments and if accounted for separately.

*** With the excess cash.

Advantages

You will be able to see the balance on the loan account at any given moment by looking at the balance sheet or the trial balance.

Disadvantages

You will not be able to see straight away from the balance sheet the amount of the cumulative loan contributions and distributions and the cumulative amount of capital gains once they have been distributed, but again that picture could be added by a properly designed capital account/partners' account as part of the financial statements (for more information see [Chapter 15](#)).

You can chose your accounting method and presentation and make sure that you chose the one that best suits your and your investors' preferences and information needs. I have seen them both in the financial statements of different funds.

Accounting for a carried interest element in the distribution calculation

Journal 3:

If the fund is in carry and there is an element of carried interest in the distribution, the situation becomes much more complicated, but generally the carried interest journal is simply a reallocation of profits/gains from the LPs to the CIP. For more details see [Chapter 14](#).

The fund of funds perspective on distributions

From a fund of funds perspective, since this type of fund invests in other funds (portfolio funds) instead of directly investing in portfolio companies, another layer of information is added to your accounting. In terms of keeping track of and reflecting in the distribution notices all the elements/types of drawdowns to reflect the information in terms of the portfolio companies from the distribution notices of the portfolio funds they invest in, there are two approaches: detailed and summarised.

Detailed information approach

The first approach encompasses keeping a detailed track of and reflecting in the drawdown notices each element/type of drawdown separately all the way down to the portfolio companies that the portfolio fund invests in. This allows the investors in the fund of funds to keep track too if required without requesting additional information from the fund of funds manager. It has to be stated that this is a relatively rare approach and the information at the portfolio-company level is usually collected as a separate exercise, and not typically presented in the fund of funds' distribution notices.

Summarised information approach and cost-recovery method

However, there are funds of funds where tracking the different element/types of distributions is particularly challenging and may take unreasonable time and/or may involve significant costs. If this is the case, they may want to adopt a different approach, namely just to provide a total amount of the distribution by portfolio fund without specifying the different elements tracked to the portfolio companies. These funds of funds usually adopt an approach which in accounting is called the cost-recovery method. The cost-recovery method is generally a revenue-recognition method under which no profit is recognised until all the cost has been recovered. In the context of private equity accounting this would mean that, if adopted, this will reflect all the distributions as a return of loan/cost (cost recovery) until the loan/capital contributions account is zero. From that point this will start to reflect all the distributions as gain (capital distributions). Keep in mind that this method may not be permitted under some accounting frameworks.

Distributions in specie

A distribution *in specie* means that instead of making a cash distribution the GP is allowed under certain circumstances and conditions (for example, with the prior written consent of the advisory committee) to make a distribution of assets (for example, shares or other securities). The value of the distributed assets is determined at their fair value. There are usually additional provisions stipulated in the LPA covering how to determine fair value, as well as the exact procedure that needs to be followed, including allowing LPs a certain time to object to the proposed distribution (for example, distribution notices to be issued at least ten days before and objections from LPs need to be received at least five days prior to the distribution). In case of objections, the GP should attempt to sell the securities.

The GP should also attempt to sell the securities if the LP is not allowed by law or regulation to hold those securities. Distributions *in specie* do not happen very often, but fund accountants need to be aware of the different (from cash distributions) rules stipulated in the LPA.

Distribution processes

In terms of processes, the distribution procedures should not vary significantly from the drawdowns procedures, except for the fact that the funds go the other way round – from the fund to the different classes of partners instead of from investors to the fund.

Distribution of carried interest

However, additional steps should be taken and controls should be put in place for distributions taking place at the carry point, at which point fund accountants need to be extremely careful as there is not much tolerance for errors where carry is concerned. For more details on carried interest see [Chapter 14](#).

Final distributions

Final verification of distributions and checking for carried interest clawbacks

With respect to final verification of distributions and checking for carried interest clawbacks, there are usually provisions in the LPA to

make sure that, on termination of the partnership (the exact deadlines are stipulated in the LPA), the aggregate of all distributions made to all classes of partners (LPs, GP and FP) are fair and square and in compliance with the LPA, and particularly that the CIP (whether the GP or the FP) has not received excessive carried interest that would be subject to clawback.

In the context of repayment of capital contributions, do not forget that for UK partnerships the capital contributions (the 0.001 percent or 0.01 percent, as the case may be, of the LPs' commitments and 20 percent of the capital contributions for the FP as explained in [Chapter 7](#)) need to be repaid to the relevant partners on termination or liquidation of the partnership.

Repayment of capital contributions

Do not forget that for UK partnerships the capital contributions need to be repaid to the relevant partners on termination or liquidation of the partnership.

Re-investment (recycling) of distributions

As explained in [Chapter 7](#), private equity funds generally do not tend to recycle except for expenses, management fees/PPS and temporary or bridge investments.

In that respect, some of the distributions would be permanent (permanent return of loan contributions/capital contributions/cost), which means that once returned they would no longer be subject to drawdown, that is, they are not redrawable. Others would be temporary (temporary return of loan contributions/capital contributions/cost), which means that they would be subject to drawdown or in other words they will be recycled because the first time round they have not been used productively, that is, invested, or in other words they will be redrawable.

Fund accountants need to be aware of and keep track of them and ideally indicate where required in distribution notices because they need to be added back to the outstanding commitment.

Summary

In this chapter, as with drawdowns in [Chapter 7](#), I have discussed the

nature of distributions, the distribution rules and the processes associated with them, comprising: the distribution calculation and the various allocation rules that may be applicable; the contents of the distribution notices (including the new ILPA guidance and templates); timing of the distributions with the three different key dates associated with them; the structure of the capital account/partners' account and the different options available to you; the accounting treatment and impact on the financial statements of the distributions; the different elements of the distributions (return-of-loan/capital/cost distribution, capital distribution and income distribution); the difference between temporary and permanent distributions, and distributions *in specie*; and the final verification of distributions and checking for carried interest clawbacks.

Talking about carried interest clawbacks, I have also touched on the implications of being in carry and particularly the impact of the carried interest on the distributions at carry point. In [Chapter 14](#) on carried interest I will discuss in detail what carried interest and waterfall are, different carried interest models, how the waterfall works, when and how to start modelling carried interest, the accounting implications and other aspects of the carried interest.

¹ When there is an income element in the selling price on disposal of the investment (for example, realisation dividend or interest received on realisation), it is debatable whether the dividend element should be charged to the income account and ultimately if you have to keep income account and capital account separately at all. But for the purpose of this example and to show that some experts may argue that it should be accounted for as investment income rather than part of the gain, I have split that element from the total gain.

Carried interest

By Mariya Stefanova

This chapter discusses:

- What is carried interest?
- What is the usual legal form of carried interest?
- Why is it called carried interest?
- Some UK and US tax aspects of carried interest
- Base-cost shift
- Carry participants
- Types of carried interest models
- Carried interest calculation
- What is a waterfall?
- What are clawback provisions?
- Accounting treatment for different carried interest schemes and GAAPs

Carried interest: substance and legal form

Carried interest or carry in private equity jargon is, in substance, a performance fee – a reward for good performance. In layman's terms it is similar to a bonus payable to the carried interest partner (CIP) for doing a good job, which means that carried interest is conditional on performance. If the general partner's/manager's performance, that is, the returns it generates for limited partners in the fund it manages hits certain targets (the hurdle), the CIP is entitled to receive (often subject to some limitations called clawback provisions) a bonus or performance fee called carried interest, which is in simplified terms usually a certain share (usually 20 percent) of the profits. Since it is performance-related, carried interest is designed to incentivise the carried interest holders; therefore it could be regarded as an incentive mechanism.

In terms of legal form, in many jurisdictions, carried interest is commonly structured as an ownership share with the relevant legal and tax implications as explained below.

Why is it called carried interest?

Based on my experience of teaching fund accountants, many people interestingly do not know why the concept is called carried interest. With reference to its etymology, many incorrectly associate the word 'interest' with bank interest (I have no idea why) rather than interest in a fund or limited partnership. Asking fund accountants about the meaning and origin of the word 'carried' usually results in stony silence in the training room.

As a brief explanation, there is a parallel to be drawn between carried interest and a highly geared investment return for the CIP. The CIP injects a very small percentage of the initial capital of the fund, often referred to as 'skin in the game', but receives a disproportionately high return on its tiny investment – the rest of its investment/interest in the fund is carried, in a way, by the limited partners (LP).

The prevailing question is whether this tiny investment is really an investment from the CIP's perspective and whether carried interest can be regarded as an equity return on realisation. I do not claim to have the definitive answer, but I would say that we can probably view it in this way.

UK and US tax aspects of carried interest

Without claiming to be tax expert, I think it is worth mentioning some tax aspects because taxation of carried interest, in the UK as well as in the US, is generally derived from the premise discussed above – namely that the CIP, whether the founder partner (FP) in the UK or the general partner (GP) in the US, has an interest (mostly carried by the LPs) in the partnership and the carried interest is a return on that investment in the fund. Therefore, part of the profits the CIP is allocated will be capital gains and will be taxed on the basis of capital-gains tax (CGT) and not income tax. If the manager/CIP were raising invoices for carried interest payments, this approach would be viewed by the tax authorities as a performance fee and, accordingly, income tax would be the appropriate form of taxation.

In the UK: base-cost shift

In the UK, in addition to the benefit in the tax treatment of carried interest mentioned above, there is an added benefit of base-cost shift (BCS). BCS is an extension of the reallocation of profits from the LPs to the CIP/FP (to be explained in detail later in the chapter) that is derived from the concept that if the interest in the partnership of the CIP/FP is carried by the LPs, later when profits/gains are to be distributed to LPs, a certain proportion (usually 20 percent), corresponding to the CIP's carried interest in the partnership, should be shifted or reallocated from the LPs to the CIP/FP. Not only are the profits and the fund's assets shifted or reallocated, but also a similar proportion of the tax-deductible base cost associated with those assets, which further reduces the effective rate of the CGT on carried interest.

With reference to tax treatments, as I have mentioned in previous chapters, they have been agreed (including carried interest and the priority profit share (PPS)) between the British Private Equity and Venture Capital Association (BVCA) and the UK's HM Revenue & Customs (Inland Revenue at that time) in two memorandums of understanding, dated May 1987 and July 2003, respectively. However, any potential future challenges to the present agreements are likely to be politically motivated as evidenced by the ongoing situation in the US, as of late 2011, which is described in more detail in the following paragraphs.

The US experience

The US Internal Revenue Service (IRS) accepts (at least currently) that carry is a 'profit interest', that is, a profit share and not remuneration. This, however, may change with the American Jobs Act of 2011 (a job-creation plan featuring tax reliefs to stimulate jobs, funded by tax increases), unveiled on September 8, 2011, which includes proposals to tax carry as ordinary income. The issue about carried interest taxation has been publicly debated for a number of years in the US.

Carried interest, which is taxed at the 15 percent capital gains rate, will increase to 20 percent from 2012. There have been calls for carried interest to be taxed as ordinary income, which from 2012 onwards the highest bracket of income tax will be 39.6 percent.¹ It is likely there will be soon be clarity about what the future holds for carried interest holders in the US.

Unlike the UK's BCS framework, there is no such concept in the US.

Carry participants

LPs

The first participants in the carry structure are the limited partners (LP). They are the fund providers that have a limited liability and are generally not involved in the management of the fund (except for in some limited cases such as in limited liability limited partnerships (LLLP)) as explained in detail in [Chapter 2](#).

GPs

The second participant is the general partner (GP). The GP is the partner that (at least theoretically) manages the fund and the investments and has unlimited liability. In US structures the GP is also a carried interest partner (CIP). For detailed explanations, refer to [Chapter 2](#).

Carried interest partner

The third participant is the CIP – whether the GP itself or set up separately as an FP, it is a partner involved in the investment management that receives the carried interest. As explained in detail in [Chapter 2](#), in the UK the CIP is traditionally established as a separate tax-efficient entity usually known as the founder partner (FP), but the GP may also receive carry as in a typical US structure.

As a reminder, when a UK partnership is established (and then either at each closing or only at the final closing as the limited partnership agreement (LPA) stipulates), the FP contributes to the partnership and usually needs to maintain 20 percent of the capital commitments (20 percent of the 0.001 percent commitment, not 20 percent of the total commitment) for an 80:20 carry scheme. In exchange for 20 percent of the equity, the FP is entitled to 20 percent of the profits: this is the carried interest. In terms of legal form, FPs are typically set up as partnerships (as a limited partnership or a limited liability partnership) and carried interest holders are partners in those partnerships, so that they can share the profits as individuals who are involved in the investment management.

In a US fund, the GP – also set up as a partnership such as a limited

partnership – receives the carried interest. Carried interest holders are usually the senior management team at the fund manager (known as the principals) and the investment team.

Types of carried interest models

There is a spectrum of different types of carried interest models. At one end the spectrum the most conservative is the whole-of-fund model with a hurdle/preferred return and no catch-up, which is the most investor-friendly. At the other end of the spectrum the most aggressive GP-friendly model is structured on a pure deal-by-deal basis, with no hurdle/preferred return and no clawback. Falling between both ends of the spectrum there are numerous hybrid structures. Specialist private equity lawyers endeavour to develop new carry arrangements, including take-as-you-go and flexible allocation (discussed below), to meet specific client requirements.

One of the most popular carried interest models – the whole-of-fund with hurdle/preferred return and catch-up – is the most likely model that you will encounter. Bear in mind though that your LPA will almost certainly deviate from that model and you also need to take into account your fund's specific circumstances. Considering the fund at the other end of the spectrum – the pure deal-by-deal model – it is not very likely that you will come across one, but the most likely modification to the structure is the hybrid partial deal-by-deal arrangement (discussed below).

Whole-of-fund carried interest model

The whole-of-fund carried interest model (also known as the all-contributions-plus-preferred-return-back-first carried interest model) is more typically prevalent in Europe where it seems to be the standard carried interest arrangement, which of course does not mean that there are no funds using deal-by-deal arrangements. The whole-of-fund structure has been adopted by more and more US funds, particularly since 2009 when Institutional Limited Partners Association (ILPA) started endorsing it in its attempt to align the LPs' interests with GPs', so this model tends to be the universal standard now. ILPA's endorsement stated:

“A standard all-contributions-plus-preferred-return-back-first model must be recognised as a best practice.”

In a whole-of-fund model, the timing of the distribution of the carried interest is delayed (typically allocated in years six to 10) compared to the deal-by-deal carry model where distribution of carry takes place a lot earlier in the fund's life when carry may be distributed after the first profitable disposal.

The main difference between the European and the US carry model is purely commercial and not related to any inherent legal differences.² The whole-of-fund model may not always be the best motivational tool for the carry holders, particularly for hungry fund managers, which is possibly the main reason why it has not been traditionally popular in the US. As this model does not recognise individual contributions, but rather reflects the success of the team as a whole, this makes it less attractive as for individual high-performers.³

The reason for the appeal of the whole-of-fund model in Europe (and increasing popularity in the US now) is due to the protection it provides for investors against early payments of carry being made despite disappointing overall fund returns. It also probably reflects the generally more conservative approach of European fund managers. In addition, for UK tax-paying carry holders, the whole-of-fund model maximises the benefit of the BCS, outlined in the same memorandum, mentioned earlier.

Whole-of-fund model: waterfall

The cash application/waterfall for a whole-of-fund arrangement works along the lines of the following five-step process:

- 1.To the GP, in payment of priority profit share (PPS)/management fee (less any amounts already drawn down).
- 2.To the LPs, until they have been repaid the outstanding loan (for UK funds)/capital (for US funds) contributions.
- 3.To the LPs, in payment of an amount equal to the preferred return (preferred return is explained below).
- 4.To the CIP (FP or GP), a catch-up – for the CIP to catch-up with the LPs (for a 20 percent carry, the catch up is 25 percent of the preferred return (because it is calculated on Step 3 and this Step 4, which means that it needs to be grossed up).
- 5.Usually an 80:20 split (or a different split according to the LPA) between the LPs and the CIP (FP or GP), respectively. The 20 percent is the carried interest.

Note: the sum of the amounts in Step 4 (the catch-up) and the 20 percent from the 80:20 split in Step 5 is the total carried interest amount.

Preferred return/hurdle

The preferred return in Step 3, which is also called hurdle (the relevant percentage of which is called the hurdle rate), is similar to a guaranteed return on the LPs' investment in the fund (subject to the fund generating enough profits). It is called hurdle because the CIP needs to pass that hurdle before it starts receiving carried interest; anything after the hurdle has been reached will be split on an 80:20 basis or whatever is stipulated in the LPA.

A typical preferred return/hurdle is 8 percent, but it could be set at another rate (always check your LPA). There may even be more than one hurdle rate and more than one carry split detailed in an LPA; for example, there may be an 80:20 split past an 8 percent hurdle and 70:30 split past a 30 percent hurdle for one fund.

Typically, the preferred return is calculated as an interest at an annual rate of a defined percentage (for example, 8 percent), compounded annually on a defined date (for example, December 31 or the date of the first drawdown), and calculated on a daily basis on the outstanding loan (in a UK fund) or capital (in a US fund) commitments.

For a quick, but slightly less accurate calculation that you may use for estimates, it could also be calculated in Excel as an IRR on the in- and out-cash flows between the fund and the LPs (drawdowns and distributions) by using the goal-seek functionality of Excel.

Please keep in mind that whole-of-fund models need to be prepared on a cumulative basis as shown in [Figure 14.1](#).

Figure 14.1: Simple whole-of-fund calculation

Total loan/capital contributions:	100,000,000
Cumulative distributions prior to this distr	150,000,000
Cumulative distributions:	250,000,000
DescriptionTotal	
clause	
Payment of PPS/manager (Point) amounts already drawn down):	
PPS/management fee due from inception	10,000,000
PPS/management fee paid	(10,000,000)
Cash outstanding to GP for PPS/manager	0
Cash available to distribute [A]	250,000,000
To the LPs, until they have been repaid the outstanding loan (for UK fund)/capital (for US funds) contributions	
Cumulative loan/capital contributed [B]	100,000,000
Actual amount to be paid under this clause	100,000,000
Cash available to distribute [C]	150,000,000

To the LPs, in payment of an amount equal to the preferred return		
Cumulative preferred return	[I	tribution date 20,000,000
Amount to be paid under this clause		20,000,000
Cash available to distribute	[I	130,000,000
To the CIP until CIP has received an amount equal to 20% of the amounts under 6.1(c) and 6.1(d) (i.e. 25% of the preferred return)		
Cumulative catch up due to	[I	preferred return 5,000,000
Actual amount to be paid under this clause	& [F]) 5,000,000	
Cash available to distribute	[C	125,000,000
Remaining amount: 80% to the LPs pro rata to the amount of their respective capital contributions and 20% to the CIP		
To LPs (80%) (80% of [G])		100,000,000
To CIP (20%) (20% of [G])		25,000,000
Cumulative distributions		230,000,000
Amounts distributed to partners prior to this distribution		(140,000,000)
Net amount to be distributed at this distribution		80,000,000

Pure deal-by-deal carried interest model

With the pure deal-by-deal carried interest model, payments are made to the CIP out of the returns of a particular investment. This payment is made once investors have received the commitments drawn down for the investment (and that investment alone) plus a preferred return on that amount (there is no hurdle for the most extreme form of pure deal-by-deal with no hurdle and no clawback). The commercial terms stipulate that on each realisation a percentage of profits is allocated to the CIP; there is no requirement for the manager to achieve an overall target rate of return; for the most extreme form, mentioned earlier in the paragraph, any losses on realisation of other investments do not impact allocations to the CIP, that is, no clawback; and no account is taken of costs or PPS/management fee incurred in the fund; and carried interest is paid from the first profitable realisation.

The pure deal-by-deal carry model is more GP-friendly and has been used predominantly in the US with its most extreme form, which has no hurdle and no clawback. That particular arrangement has become more or less extinct and is very rarely seen in new LPAs as it portends to a low level of investor protection. Given the global financial crisis, difficult fundraising conditions and increasing LP scrutiny – helped by ILPA trying to swing the pendulum of negotiating powers more towards LPs and thereby endorsing the whole-of-fund as best practice and suggesting enhancements to the deal-by-deal model pointing to the less ‘aggressive’ hybrid models (discussed below and more stringent clawback provisions) – there is probably no way back in the near future for the extreme pure deal-by-deal model with no hurdle and no clawback carry arrangement.

What is positive about the deal-by-deal model is that it is a motivational tool for an investment team, designed to meet the requirements of ambitious executives and fund managers. It can bring forward carry payments by many years compared to the whole-of-fund carry model, which is good for the carried interest holders, but not so good for LPs.

Since the pure deal-by-deal carry model does not monitor the overall performance/return of the fund, modelling it is much easier than the whole-of-fund carry model.

Hybrid carried interest models

In terms of the level of LP protection there is large number of hybrid carried interest models in between the two extremes – the whole-of-fund with hurdle and no catchup and the pure deal-by-deal with no hurdle and no clawback. Each LPA has specific commercial terms, which set out to align the interests of GPs and LPs and to strike a balance between the investment team's and the LPs' needs. Fund accountants, who probably do not have a say in the design of the carry model, need to read the LPA provisions very carefully and consider them from the outset to ascertain exactly where on the spectrum the specific model of the fund they are looking after sits.

Partial deal-by-deal

For some LPs a deal-by-deal model with a suitable escrow arrangement to protect their interests might be a good solution. For others, particularly European LPs used to the whole-of-fund model, this might be lacking enough investor protection. Models that meet the needs of such investors have been developed over time and most of them would revolt around the partial deal-by-deal arrangement. Although there is an infinite number of hybrid models in terms of LP protection, there is one which is well established (of course taking into account the specifics of different LPAs with the relevant level of LP protection), that is, the partial deal-by-deal with whole-of-fund calculation and clawback, which is increasingly replacing the pure deal-by-deal model. This model is commercially similar to the whole-of-fund with hurdle model, which has a facility to make payments on account, but subject to certain limitations called clawback provisions.

The commercial terms of this model, often called the 'take-as-you-go' model by lawyers, feature carried interest payments made out of the returns of a particular investment.

However, carried interest holders begin to receive carry as soon as

they have returned the drawn-down capital and paid a preferred return on the fund's realised investments (that is, for the investment plus any outstanding amounts for previously realised investments). Loan/capital contributions on investments that still remain unrealised within the fund do not need to be returned. However, usually permanent write-offs (and sometimes writedowns) are usually considered realised and contributions drawn down for them should also be returned before carry.

As a simplified explanation, whenever a fund makes a realisation and if there is a profit, the fund manager assesses the whole fund to see if the fund is still on track to return carry. It is essentially a whole-fund carry calculation with a facility to make payments on account as the fund goes through its lifecycle, as long as returns seem to be on track. Very often in partial deal-by-deal models, a proportionate share of the acquisition costs, fund expenses and PPS/management fee of the fund's realised investments are also returned before the preferred return.

However, modelling a partial deal-by-deal arrangement is much more difficult than the whole-of-fund and pure deal-by-deal carried interest models. Attempting to future-proof a model is particularly challenging as sometimes it works perfectly well for the first realisation/distribution, but subsequently breaks down. It is worth spending more time at the beginning to think about how to provide for all eventualities, test the model with different scenarios, most importantly by simulating future overall performance deterioration and triggered clawback provisions.

Carried interest modelling – useful advice

Carried interest modelling is a complex area that requires not only good modelling skills (actually if you understand the dynamics of an LPA you can prepare a carry model without superb modelling skills as it is just a tool), but most importantly a very good understanding of the commercial terms laid out in the LPA. The problem is that sometimes the wording in the LPA is not clear and/or detailed enough and needs further interpretation/clarification.

I have even come across, with all due respect to lawyers, inaccurately (I am trying to avoid the word 'wrongly') worded clauses, particularly as formulae (where present) are concerned. To avoid that, make sure that GPs, incentive experts, lawyers and accountants work side by side when originally designing the carry arrangement and drafting its terms in the LPA.

In addition, make sure that you plan it rather earlier in the life of the fund even for a whole-of-fund carry arrangements. In my experience, what happens very often is that if you start modelling the carry later in the life of the fund – more towards the second trigger point when the fund is near repayment of loan/capital contributions, as explained later on in the chapter, and if the LPA is not very clear or detailed enough (or inaccurate in some cases) and you need further interpretation/clarification of what the real intention of the LPA should be, you may find out that whoever has been involved in the masterminding of the model – whether a lawyer or someone at the GP/manager – might have left the firm and getting to the bottom of the problem might prove to be quite a challenge.

As far as carried interest modelling is concerned, make sure that someone sufficiently experienced, who knows enough about carry models and fund dynamics is good at reading LPAs and understands your LPA (the whole of it, not just the waterfall section), designs it and really future-proofs it to be as robust and resistant to any future eventualities (for example, negative carry) as possible.

On a purely technical level, it is good that the model is as automated as possible with as few manual interventions as possible. Make sure the automation provides for and tests the model for different possible scenarios (again definitely factoring in a decreased overall performance of the fund and a possible negative carry later on), which is a very important consideration.

Definition of a waterfall

The waterfall is the sequence whereby cash proceeds from the sale of and income from portfolio companies (including dividends, interest on loan notes and other investment income) are distributed. It is essentially the application of cash or the way that the money flows down to different classes of partners (LPs, GP and FP) in a distribution, hence the term waterfall. In LPAs it is usually referred to as ‘application of cash’. It refers to allocation of cash (and distribution) to different classes of investors, which is not to be confused with the allocation of income and gains that usually sits in a separate section of the LPA. When filing the fund the waterfall does not necessarily need to be aligned with the cash distributions, although towards the end of the fund, the aim is usually for both to be aligned.

Clawback provisions

As stipulated in an LPA, clawback provisions exist to protect LPs from overpaying the CIP, which is very important, particularly for deal-by-deal carry models. A clawback provision can smooth out situations where initial high multiples are followed by disappointing returns from later realisations, which would mean that more carry is paid on earlier deals and therefore has to be clawed back from the CIP to repay the LPs.

There is a great variety of clawback provisions. Escrow accounts are probably among the most popular with the proceeds held in an account (usually under CIP/GP control, but for the benefit of LPs) from which the CIP may make withdrawals subject to certain rules, in case that subsequent losses are incurred.

The rules under which the CIP may draw money out of the escrow account are specific to each fund and are stipulated in the LPA, so read them carefully.

An alternative to a clawback provision could be paying only a certain percentage of the carry entitlement (for example, 50 percent) with the rest going back to LPs as an additional distribution. This could be treated as a repayment of outstanding cost of investments and such repayment allocated to the next investment to be realised and to subsequent investments in the order of realisation.

Fund accountants need to be well aware of clawback provisions, not just to monitor if the LPA is adhered to, but also because clawbacks play a significant role in terms of determining the accounting for carried interest, as explained later on in the chapter.

Accounting treatment for carried interest

Fee expense or profit allocation?

As usual you need to read the fund LPA, but this time in addition to that read the CIP's LPA because some of the nuances (for example, clawbacks from individual carried interests holders) that you need in order to be able to decide when you should start accounting for it, would be in the CIP's LPA.

Next, you should consider the accounting framework/GAAP you are reporting under. Regardless of the GAAP there are essentially two possible treatments which can be applied:

- A performance/incentive fee (expense charged to profit & loss) to the CIP (FP or GP).
- A reallocation of profits (net income and gains) from LPs to the CIP (FP or GP).

Carry amounts could be considered as:

- either a disproportionate income/profit allocation on the CIP's interest (carried by the LPs) in the partnership; or
- a compensation/bonus arrangement generally if not structured properly.

Carried interest should be properly structured in line with the fund sponsor's intention using the most beneficial tax treatment in the relevant jurisdiction and the accounting should conform to the structure stipulated in the LPA.

In certain partnerships and certain jurisdictions (usually offshore and those gravitating around the US, for example, Cayman), carried interest is treated as a performance fee (according to its substance and legal form in those jurisdictions) and therefore recorded as an expense. This is a straightforward treatment, which does not require further analysis, so I will focus on the more common and more complex treatment where carry is instead treated as an investment return, not a performance fee.

Given that in most jurisdictions carried interest is structured in a tax-efficient way as an ownership share and it can be regarded as an investment return and not a performance fee, then bearing in mind this concept, you have to rule out that it goes through profit & loss because transactions with shareholders/partners are not treated as such. So, if it is not a performance fee, then how should you account for it?

Consider the following: the CIP's carry is an equity return on realisation with regards to its interest in the fund carried by the LPs. So, when profits/gains are to be distributed to LPs it is actually shifting a certain proportion (usually 20 percent) from the profits corresponding to the CIP's share, from LPs to CIP, which means that carried interest can be regarded as a profit allocation (or rather reallocation) mechanism.

In essence, as far as accounting is concerned, except when it is treated as a performance fee and charged to profit & loss as an expense, carry is generally a reallocation of profits (net income and gains) from the LPs' capital account to the CIP's capital account.

When accounting for and presenting carry in the financial statements,

accountants do that based on a very important assumption, namely that the partnership is to be liquidated/wound up on the reporting date. Therefore, this requires you to reflect the effect of the carried interest (including clawback provisions) based on that assumption, that is, as if it had realised all assets and settled all liabilities at the fair value reported in the financial statements. The next process is to allocate all gains and losses and distribute the net assets to each class of partner at the reporting date in accordance with the LPA provisions.

However, for the analysis to work out and to give you a more accurate picture of the accounting treatments, it is important to discuss the different types of carried interest schemes and accounting frameworks as it works slightly differently for each one of them.

Analysis: carried interest models and accounting frameworks/GAAPs

Whole-of-fund carried interest model under IFRS

The ultimate question is: will carried interest be recognised and if so at what point? There are some important points to consider before deciding on the answer of this question – when to start accounting for carried interest – whether to recognise/accrue for it earlier in the life of the fund or to wait until actual cash payment is made. There are also some obvious triggers that would provide good pointers about when to recognise carried interest.

The first trigger point is when the value of the assets is higher than the outstanding loan account (in UK funds) or the capital-contributions account (in US funds) and past the hurdle. Although the fair value of the private equity investments, which accounts for most of the net asset value (NAV) of the fund is highly hypothetical and subjective, this is time to consider accounting for carry. This is based on the same assumption, mentioned above, namely that the partnership is liquidated/wound up on the reporting date and it had realised all assets and settled all liabilities at the fair value reported in the financial statements, and then allocated all gains and losses and distributed the net assets to each class of partner at the reporting date in accordance with its LPA provisions. Since the NAV of the fund is sufficiently high to hypothetically pay out carried interest to the CIP, and because of the accrual concept, it is time to consider accounting for carry. Before that point, there is no need to do anything in terms of accounting, although it would be a good idea to start modelling the carry and testing it in preparation for that trigger point.

The second trigger point is when the loan-contributions account (in UK funds) or capital-contributions account (in US funds) plus the hurdle has been repaid to the LPs, after which point 20 percent of all the proceeds (essentially the carried interest) is due to the CIP, in which case this means that in most of the cases there would probably be little choice but to account for it.

With regards to the period between the two trigger points, there are two potential arguments with two accounting approaches, discussion of which follows.

First approach – no-liability-no-recognition approach

This first approach is more in line with IFRS, but some argue that the second approach is also in line with IFRS, so I will leave it to you to decide which approach you adopt, depending on which arguments seem more convincing and of course subject to your auditor's approval.

Unfortunately, for IFRS (and the same goes for UK GAAP) there is no guidance specific to private equity or at least generally to investment entities such as that provided by the American Institute of Certified Public Accountants (AICPA) for US GAAP, which informs exactly when to recognise or how to account for or present carry in the financial statements.

Back to the first approach: before the first trigger point, do not do anything, but monitor and make sure that the fund is not past that theoretical threshold.

For the period between trigger point one and two as explained above, the CIP can, hypothetically, start allocating carry based on the assumption that all the partnership's assets are realised on the reporting date at the assets' fair value, past the hurdle. However, the partnership's investments are usually not marketable or feature limited liquidity that interim valuations are highly subjective. Therefore, the argument that recognition needs to be delayed until gains can be measured objectively, or to put it in a different way, if the assets are realised (hypothetically) and they are realised at that value (that is, the fair value which is another hypothesis), then the carry partner will receive that amount, but that is just a hypothesis and there is no liability to the CIP based on that hypothesis.

Accordingly, considering the highly subjective nature of private equity valuations and that carry is not due to the CIP, that is, this is not a liability, the argument follows that carried interest cannot be put

through the accounts.

However, for those for whom this argument seems appealing, it would be very useful if there is a disclosure note in the notes to the financial statements, such as a 'contingency' note but not a 'contingent liability' note as it cannot be a liability. Such a note could read as follows: *'In the event that all the assets were sold at that carrying value, an amount of £X million will be payable to the carried interest partner.'*

Bear in mind that this is a very important piece of information for the investors. My recommendation would be that you make your waterfall calculation at that point in time and you run the numbers through your waterfall model and make this disclosure based on the output from the model in the notes to the accounts.

After the second trigger point, as explained above, in most of the cases there would not be much choice but to account for it, that is, either, to reallocate 20 percent of the profits realised due to the CIP (a liability at that point) from the LPs to the CIP as it has been previously treated by many funds, or as an expense, if you chose to follow a relatively recent official treatment recommended by the Big Four accountancy firms as explained in the next paragraph; reallocate 20 percent of the net assets from the LPs to the CIP and of course account for the cash distribution in line with the cash waterfall.

What I will say now may sound as a bit of a surprise (and not a pleasant one) to some of you that may call for a change in your treatment of carried interest. Traditionally, as explained earlier, even under IFRS, carried interest has been treated as a reallocation of profit/gain, but now all the technical experts at the Big Four accountancy firms have agreed that carried interest under IFRS is to be treated as an expense. What, for example PricewaterhouseCoopers states in one of its publications is "unlike US GAAP where a carried interest may be presented as an allocation, a carried interest under IFRS will always be reflected as an expense (when the appropriately thresholds have been met)",⁴ that is after the second trigger point which is past hurdle, as described earlier in the chapter.

The argument, despite the legal form, is basically that: "A service is rendered by the GP, which gives rise to a financial liability (with a corresponding expense) as soon as the service is rendered as the obligation to pay meets the definition of financial liability in IAS 39 (obligation to deliver cash arising under a contractual agreement) and such obligation being recorded in income statement."⁵ I would say that

this argument has its merits, after all, despite the fact that carry has been traditionally structured by the lawyers in your LPAs as a profit share, not a consideration in exchange for a service rendered by the CIP to the fund, we all know what the carried interest is in essence, plain and simple – a performance fee.

Second approach – the accrual approach

The counter argument is that when accountants prepare accounts, we prepare them on an accrual basis, on the basis of prudence and looking forward. If the assets are sold at that value, and the valuation is in excess of the outstanding loan, the relevant proportion should go to the CIP. If the valuation exceeds the amount of the outstanding loans, this excess amount (which is in revaluation reserve) is allocated to the CIP.

There is usually a single revaluation reserve, so a good approach would be to split the revaluation reserve into 'revaluation reserve' and 'carry reserve'/'provision for carry' (or anything that you deem appropriate that would make best sense to the investors), which is allocated to the relevant classes of partners, that is, the LPs and the CIP, respectively.

If accounted for under this accrual approach, this is all that is required when accounting for carry at this point – split of the excess revaluation reserve by class of partners in the partners' accounts and still no liability to the CIP.

Keep in mind that this is a tax-sensitive issue and you may want to think carefully about the presentation in the accounts as the relevant tax authorities may be tempted to follow your accounting treatment and presentation. After the second trigger point, it should be similar to the first approach, that is, to account for carry in the majority of the cases.

Partial deal-by-deal carry model

In the time before the first trigger point, similar to the whole-of-fund carry, nothing needs to be done. Between the first and the second trigger points, cash distributions should be in line with the cash waterfall as detailed in the LPA, potentially meaning the carry arising from the realisation of a specific investment will be paid into an escrow account as stipulated by the LPA clawback provisions. The LPA will detail when you can draw from the escrow account, so a careful consideration of those provisions is required. However, it is usually not a straightforward consideration as it would depend on the circumstances/the provisions in the LPA and the likelihood of the money leaving the escrow account.

A very simplistic approach to take is that if money is sitting in the escrow account then it should be recognised.

There should be no allocation by different classes of partners of the remaining net assets. Again be very careful with the tax implications, as taxation would generally take place on the earlier date of the realisation or the allocation of the proceeds – consulting tax advisers before deciding on the presentation of carry in the accounts is advisable.

After the second trigger point, it should be similar to whole-of-fund. In addition, you need to think about recognising the clawback in case that the fund falls in value.

Pure deal-by-deal model

For pure deal-by-deal models, there is a revaluation reserve for each deal. Generally, at realisation point, the CIP will participate in the share of the profits (losses usually excluded) and the profits are allocated on that basis and the cash distributions at that point are in line with profits realised, so what I would generally say is that, if the carry has been paid and if the money has been transferred to the escrow account, most likely it would be a pretty safe bet to recognise it.

UK GAAP (FRS 26)

Treatment under UK GAAP with FRS 26 application is similar to IFRS.

Old UK GAAP

The lower of cost or fair value (no revaluation, impairment only): for all schemes profit is to be reallocated on realisation and the cash follows the distribution waterfall.

US GAAP

As mentioned earlier, unlike IFRS and UK GAAP, under US GAAP there are specific rules for investment companies issued by the AICPA, so you can find much more specific guidance for investment companies, including private equity funds.

Back to the subject of carried interest. Should cumulative unrealised gains (losses), carried interest and clawback be reflected in the equity balances of each class of partner at the balance sheet date? This question reflects an enquiry made to the AICPA. Its answer states if a non-registered investment partnership (usually a private equity fund) reports capital by investor class (such as LPs or GP), cumulative unrealised gains (losses), as well as carried interest and clawback provisions, would be reflected in the equity balances of each class of

partner.

This would be as if the investment company had realised all assets and settled all liabilities at the fair value reported in the financial statements and allocated all gains and losses and distributed the net assets to each class of partner at the reporting date consistent with the provisions of the partnership's governing document.⁶ This may not necessarily be the case under other GAAPs, although the carried interest treatment is considered by experts to be broadly similar to the FRS treatment.

LPA/investordefined GAAP

If the LPA specifies that treatment, do follow it, but basically the treatment is flexible. Take an appropriate approach as long as it is stipulated in the LPA and it is disclosed and agreed with the auditors.

Some complications

Sometimes there are complications that could mess up your carry models – the most unpleasant for accountants is when there is a drawdown after the fund has gone into carry, which means the fund is technically no longer in carry. The best approach is basically to ignore the hurdle and continue to allocate to the LPs until that new drawdown (plus hurdle) has been repaid. An equalisation should be done to reallocate and to ensure everybody is at the position they should be.

Another complication in your LPA may be if you have annual pools. Basically what happens is that each year's investments become a separate scheme. Keep in mind in this case that typically follow-on investments revert back to the year of the original investments.

Carried interest and AIFMD

Carried interest is a complex subject, which is not very well understood outside of the industry and may be quite a challenge in new legislation and regulation. The carry treatment under the Alternative Investment Fund Managers' Directive (AIFMD) ignores the legal nature of carry that discussed earlier in the chapter, namely that it is a return on the investment put into the fund by the CIP and therefore it is exposed to the same risks as the LPs. AIFMD explicitly refers to carried interest as "excluding any return on investment made in the Alternative Investment Fund (AIF)". Therefore, carry as usually understood in the private equity sector, is not covered by AIFMD, and assuming this is the case, there may be additional deferred remuneration since AIFMD

requires restrictions on variable remuneration that can be paid without deferral.

This and some other specifics of carried interest, for example, in a typical European carried interest scheme (the whole-of-fund carry arrangement), carried interest is allocated and paid to the CIP only after the loan/capital contributions have been returned to the investors, leave the impression that the European regulation, at least as for now, has not appropriately considered carried interest and the treatment thereof. It is hoped that the outcome of Level 2 of AIFMD implementation will resolve this disconnect.

If not, there will be significant additional costs in changing partnership agreements and internal procedures in order to ensure that the requirement for some form of remuneration deferral is met.⁷

Summary

Carry is one of the most complex topics in private equity accounting. Unfortunately there is very little information available in the public domain, so I hope that I have managed to shed some further light on the subject for you.

In this chapter I have discussed the concept of carried interest, its nature in substance, as well as its legal form, some tax aspects, including the tax concept of based-cost shift or BCS used in the UK. I have also discussed the different types of carried interest models: the whole-of-fund model is more popular in Europe, which compares with its spectrum opposite, the deal-by-deal model, with many hybrid models in between. I have examined the accounting treatment of the different models, mentioning the treatment under some recognised accounting frameworks, and finally I have mentioned some complications that you encounter and their potential resolutions, as well as some potential (if not resolved in the Level-2 measures) issues with the AIFMD.

Now that the most complex subject of private equity accounting has been fully addressed, in the next chapter I will discuss a more all-encompassing subject – the fund financial statements format and how private equity financial statements are different from other entities' financial statements.

¹ President Obama's carry tax is a blunt instrument, Private Equity International, September 16, 2011.

- ² The Debevoise & Plimpton European Private Equity Handbook, Debevoise & Plimpton, 2004.
- ³ Getting flexible: new strategies for whole-of-fund carried interest, Piers Warburton, Ashurst Investment Funds Update, April 2006.
- ⁴ PwC Similarities & Differences: A Comparison of US GAAP and IFRS for investment companies, PricewaterhouseCoopers LLP, February 2011.
- ⁵ Ibid.
- ⁶ American Institute of Certified Public Accountants (AICPA), TIS Section 6910 Investment Companies, Technical Questions and Answers, Question 29.
- ⁷ Jonathan Martin, Operating conditions: operating in the new 'norm', The European Private Equity Compliance Guide, July 2011, PEI.

Fund financial statements

By Mariya Stefanova

This chapter discusses:

- Why a set of financial statements for a private equity fund is different from other non-investment and investment entities' financial statements
- Financial statements formats
- Financial statements under IFRS
- Financial statements under UK GAAP
- Qualifying and non-qualifying partnerships
- Financial statements under investor-defined accounting framework (LPA GAAP)
- Financial statements under US GAAP

Private equity fund financial statements

This chapter has a clear link to [Chapter 3](#), which covers the uniqueness of private equity accounting, but in the following pages the focus of discussion is firmly on the format of the financial statements where private equity's uniqueness crystallises in its pure form.

The following list serves as a brief reminder of the reasons for private equity's uniqueness mapped out in [Chapter 3](#):

1. Legal form of the entity we account for – limited partnership with its different investor classes (LPs, GP and FP) and allocations to those classes.
2. Limited partnership agreement (LPA) that basically rules the accounts within the relevant accounting framework.
3. Purpose and nature of a private equity fund's activities.
4. Needs of the main users of financial statements – investors/LPs and their reporting requirements.

5. In certain jurisdictions (such as the UK), a unique accounting framework is used – the investor-defined accounting framework, also called LPA GAAP.

A couple of other factors need to be added to this list, which rather indirectly influence private equity accounting systems and possibly fund financial statements:

6. Industry guidance, which may not necessarily be reflected in the financial statements, but will influence the way the information has been set up and organised in the accounting system.

7. Regulatory requirements: existing and future regulation and legislation in all jurisdictions that will impact private equity.

These seven combined factors crystallise in the final product: the fund's financial statements delivered to all investors/limited partners (LP). The overriding intention is that financial statements are sufficiently clear and informative to assist investors making decisions about allocations and monitoring their investments.

Financial statements formats

The combination of these seven factors helps to determine the format of the financial statements. You may consider that the requirements and varying best practices in different jurisdictions, GAAPs and fund types, and investors wishing to tailor them to their specific needs, would result in financial statements being highly individual. However, if you look closely at them they are not so remotely different and have more similarities than differences, even when you consider the following:

- GAAP requirements.
- LPA requirements.
- Regulatory requirements.
- Industry best practice.
- Investors' specific requirements.

In light of this background, I will discuss the different formats of private equity fund financial statements under the three most frequently used and recognised accounting frameworks /GAAPs – IFRS, US GAAP and UK GAAP, highlighting their specifics.

IFRS

Some of you apply full IFRS, others, probably more often, apply IFRS with some departures (for example, departure from consolidation). Whatever the case may be, I hope that you will find this part of the chapter informative.

If you are looking for some general guidance, the Big Four offer free online resources including a number of illustrative publications covering financial statements under the main recognised accounting frameworks. Unfortunately only one of these online resources specifically refers to private equity. I often refer the resource offered by PricewaterhouseCoopers, which may not look very much like your own financial statements. In fact, I have not seen many financial statements closely resembling this template, but I do find it quite useful and use it as a reference point when I have any doubts with regards to a certain treatment or a presentation.

The main applicable standards that you need to consult in preparing your IFRS fund financial statements comprise:

- *IAS 1 Presentation of Financial Statements*;
- *IAS 39 Financial Instruments: Recognition and Measurement* (to be replaced by *IFRS 9 Financial Instruments*, as discussed in [Chapter 9](#)); and
- *IFRS 7 Financial Instruments: Disclosures*.

Of course, a number of other standards are applicable, but these three are of paramount importance when you prepare your financial statements.

IAS 1 presentation of financial statements

Remember that there will be amendments to IAS 1 effective from July 1, 2012.

The following refers to elements of financial statements, usually referred to as 'primary statements', and the names of those elements. With reference to paragraph 10 of IAS 1, a complete set of financial statements are included as follows:

- Statement of financial position (previously 'balance sheet') as at the end of the period.
- Statement of comprehensive income for the period.
- Statement of changes in equity for the period.
- Statement of cash flows (previously cash flow statement) for the period.

- Notes, comprising a summary of significant accounting policies and other explanatory information.
- Statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements or when it reclassifies items in its financial statements.

When the changes to the names of the statements were first introduced in 2007 (effective from January 1, 2009), there was a common misconception that these names were mandatory, but the same paragraph 10 states that “an entity may use titles for the statements other than those used in the standard (IAS 1)”. So, if you (or your investors) are still comfortable with the old names, such as balance sheet or profit & loss, there is no reason as far as the standard is concerned why you should not use them.

Comparative information

Under IFRS, unlike US GAAP, comparatives are imperative and of particular importance. Paragraph 38 stipulates that comparative information in respect of the previous period for all amounts reported in the current period's financial statements needs to be disclosed, except when IFRSs permit or require otherwise. In addition, comparative information for narrative and descriptive information needs to be included when it is relevant to an understanding of the current period's financial statements.

Consistency of presentation

IAS 1 requires that an entity retains the presentation and classification of items in the financial statements from one period to the next, unless there are extraordinary circumstances as described in the standard.

Frequency of reporting

IAS 1 requires that an entity presents a complete set of financial statements (including comparative information) at least annually, but the industry standard is for quarterly accounts usually within 45 days (extended for funds of funds) from the quarter-end date and annual audited (not a requirement in some jurisdictions such as Cayman) accounts within 90 days (also extended for funds of funds). For more information on the best practice in terms of quarterly/annual reports delivery deadlines, refer to *ILPA Quarterly Reporting Standards Best Practices*, which were released in late October 2011.

Statement of comprehensive income

With a single or a two-part statement of comprehensive income is there still a choice? Under IAS 1, currently (as of October 2011), the entity can choose whether to present:

- a single statement of comprehensive income; or
- two statements – a separate income statement (displaying components of profit or loss) and a second statement of comprehensive income, starting with profit or loss and displaying components of other comprehensive income.

As a result of a joint project between the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) to create a common set of high-quality global accounting standards, IASB issued amendments to *IAS 1 Financial Statement Presentation* on June 16, 2011. These amendments improve how we present components of other comprehensive income. FASB issued equivalent requirements on the same day. With this joint project, the two boards aligned IFRS and US GAAP in terms of the presentation of items in other comprehensive income (OCI), since OCI items were presented very differently under the two GAAPs. The final goal is to lead to improved consistency and clarity in the presentation of those items. The new requirements are effective for annual periods beginning on or after July 1, 2012.¹

I'll shed some more light on the debate about the single/continuous statement of comprehensive income versus a two-part statement. Although in the exposure draft *Presentation of Items of Other Comprehensive Income* published simultaneously by both boards in May 2010, IASB and FASB proposed to require all items of income and expense to be presented in a continuous statement with two sections – profit or loss and OCI. This removed the existing option in IFRS to present profit or loss and OCI in two statements. As a result of submitted comments and FASB's subsequent decision not to require a single statement, to amend its existing requirements and to introduce the separate presentation of OCI items, IASB decided to allow flexibility in the presentation and keep the option to present profit or loss items in a separate statement of profit or loss.

Originally, IASB made this proposal because it considered that allowing entities to present items in profit or loss and OCI in separate statements creates an unnecessary level of complexity. More importantly, however, it may make it difficult for users to understand what those statements actually represent and how they interact with each other. It turned out, though, that their fears were unjustified and

the constituents preferred a separate presentation, which was reflected in the final version of the amendments to IAS 1.²

In addition to clarifying the OCI presentation, other amendments to IAS 1 are:

- establishing a distinction between different OCI items; and
- presenting income tax on OCI items, but that will not be subject to discussion in this chapter (or in the book).

Establishing a distinction between different OCI items is in fact the main change in the whole document. Entities will be required to group items together in OCI on the basis of whether they would be subsequently reclassified (recycled) from OCI to the profit or loss, when specified conditions are met. A common misunderstanding has been that the split between profit or loss and OCI is on the basis of realised versus unrealised gains and that was due to the lack of distinction between the items in OCI, which according to IASB, is not and has never been the case. By requiring OCI items to be grouped (within the OCI itself) on this new clarified basis, their potential effect on profit or loss in future periods is expected to be clearer. The amendments do not address which items need to be reclassified though.³

Various contents.

They generally comprise line items, headings, order of items, subtotals and totals. There is a minimum requirement about the contents of the statement of comprehensive income, set out in paragraph 82, including revenue, profit or loss, each component of other comprehensive income and total comprehensive income.

Bear in mind that you do not necessarily need to use the exact names of the captions used in the standard as paragraph 8 of IAS 1 stipulates that although the standard uses the terms 'other comprehensive income', 'profit or loss' and 'total comprehensive income', an entity may use other terms to describe the totals as long as the meaning is clear. For example, an entity may use the term 'net income' to describe profit or loss.

With reference to paragraph 85, you can also present additional line items, headings and subtotals when such a presentation is relevant to understanding the entity's financial performance. Paragraph 86 also allows you to amend the description used and the ordering of the items when this is necessary to explain the elements of financial performance. The bottom line is you can make your statement of

comprehensive income more specific, relevant, detailed or summarised, so that it can better reflect the nature and the activities of the entity. Specifically, an investment entity (a private equity fund organised as a partnership) investing in private unlisted companies with the investment objective to seek medium-to-long-term investments. An example of single statement of comprehensive income organised by nature of expense under IFRS for a private equity fund is presented in [Figure 15.1](#) over the page.

Material items

When income or expense items are material, an entity will disclose their nature and amount separately. Examples of such material items could be, for example, an investment write-down, write-off or disposal, a litigation settlement, a discontinued operation and other material items.

Expenses analysis – by nature or by functionality

An analysis of the expenses recognised in profit or loss needs to be presented, but there is some choice about whether to present them by nature or by functionality. The solution is whichever classification provides more relevant and reliable information, but usually in practice the choice is by nature and somehow for an investment entity that choice appears natural. In [Figure 15.1](#) the expenses are presented using the bynature classification.

With respect to offsetting items of income and expense, it is generally now permissible to offset income and expense items unless certain criteria are met.

Extraordinary items

No income or expense items are allowed to be presented as extraordinary items in the statement of comprehensive income or the separate income statement (if presented) or in the notes.

Figure 15.1: Sample statement of comprehensive income under IFRS	
Statement of comprehensive income* for the year ended December 31, 2010	
(All figures stated in £)	2009
Income	
Interest income **	1,500,000
Dividend income	100,000
Net realised gains on finan	
Net changes in fair value o	13,500,000
Net foreign currency gains,	(500)
Total net income	15,099,500
Expenses	
Carried interest charge ***	-

Management fee	(2,000,000)
Administration fees	(120,000)
Deal costs	(50,000)
Abort costs	(10,000)
Legal fees	(14,500)
Other professional fees	(5,000)
Total operating expenses	(2,199,500)
Operating profit/(loss)	12,900,000
Other comprehensive inc	-
Total comprehensive inc	12,900,000

* Single statement, by nature of expense.

** This item includes only interest income on investments (e.g.. on loan notes) not bank interest.

*** It is not very likely (unless the fund has a deal-by-deal carried interest model) that there would be carried interest charge that early (in the second year) in the life of the fund, but this is to demonstrate that now under IFRS (contrary to the more traditional presentation previously) carried interest should be treated as an expense rather than as an allocation of profit, as explained in [Chapter 14](#).

Reclassification adjustments

Reclassification adjustments of amounts previously recognised in other comprehensive income to profit or loss are included with the related component of other comprehensive income in the period that the adjustment is reclassified to profit or loss. And they may be presented either in the statement of comprehensive income or in the notes.

Realised and unrealised gains (losses) on investments – presentation

As noted in [Chapter 9](#), unlike US GAAP, there is no requirement to disclose net realised gains (losses) and net change in unrealised appreciation (depreciation) separately. However, in practice they are often presented separately either on the face of the statement of comprehensive income or in the notes as accountants still feel that such a distinction should be made. IFRS also requires net gains (losses) on foreign currency transactions to be disclosed separately except for those arising on financial instruments measured at fair value through profit or loss (which is basically similar to US GAAP).

Therefore, under IFRS, contrary to US GAAP, the distinction between realised and unrealised gains (losses) does not seem to be as important as the distinction between gains (losses) from changes in fair value and gains (losses) from foreign currency transactions.

In addition, paragraph 20(a)(1) of IFRS 7 requires that net gains and losses should be separately disclosed for different types of financial assets (for example, at fair value through profit or loss and available-

for-sale).

Withholding taxes

As explained in **Chapter 11**, under IFRS, income is presented gross (of the tax expense – the withholding tax) in the statement of comprehensive income. The withholding taxes should be presented as a separate component of income tax (expense) for the period, required by paragraph 82(d) of IAS 1, which means that they should be tracked and recorded separately. In practice, that area is often overlooked, particularly if the accounting is outsourced to a third party due to the lack of or insufficient information from the clients (the fund GP).

Statement of financial position

Similar to the statement of comprehensive income, IAS 1 has a minimum requirement for the contents of the statement of financial position (previously referred to 'balance sheet') and would allow additional line items, headings and subtotals when such presentation is relevant to an understanding of the entity's financial position. The standard does not prescribe the order or format in which an entity presents items, but simply lists some.

The descriptions used and the ordering of items or aggregation of similar items may be amended according to the nature of the entity and its transactions to provide relevant information to an understanding of the entity's financial position. Line items are included when size, nature and function of an item or aggregation of similar items are important enough to call for a separate presentation that is relevant to an understanding of the entity's financial position.

Current/noncurrent distinction

There are two possible presentations:

- Current and non-current assets, and current and non-current liabilities, as separate classifications.
- Presentation based on liquidity.

Generally, entities should be using the first presentation, except when the second one provides information that is reliable and more relevant.

For an entity supplying goods or services within a clearly identifiable operating cycle, current/non-current assets and liabilities are relevant, but that is not exactly the case with private equity funds. A presentation by order (increasing or decreasing) of liquidity may be considered more appropriate. A mixed basis of presentation of the two methods is also allowed – for some of the assets and liabilities using a

current/non-current classification and for others by order of liquidity. But whichever method of presentation is adopted, an entity has to disclose the amount expected to be recovered or settled after more than 12 months for each asset and liability line item that combines amounts expected to be recovered or settled: (a) no more than 12 months after the reporting period and (b) more than 12 months after the reporting period.⁴

The standard uses the term 'non-current' to include tangible, intangible and financial assets of a long-term nature, a description which appears in [Figure 15.2](#), but it does not prohibit the use of alternative descriptions as long as the meaning is clear.

Net-assets measurement

The net assets measurement is similar to US GAAP, that is, the residual value of the assets net of liabilities. For puttable instruments (capital and loan contributions), recognised as liabilities (loan contributions in a UK partnership) as discussed previously, the liability is measured at the redemption amount with changes in that amount recognised in profit or loss.

Below is a an example of a presentation of a statement of financial position still preferred in practice by UK partnerships reporting under IFRS as it better reflects the LPA with the partners' accounts (for example, capital contribution, loan contribution, and income account) defined in it. The major difference between this presentation and the one used in the *PwC Illustrative IFRS Financial Statements for Private Equity 2009* (used as a reference point for by-the-book IFRS presentation) is in the bottom equity/('Presented by') part with regards to the treatment of partners' capital – that is, the issue of liability versus equity which has been discussed in detail in [Chapter 7](#).

In practice, though, it is still not untypical for the partners' capital to be presented rather as equity, which is shown in [Figure 15.2](#). In my experience, many auditors (particularly in the UK where the issue is well understood by the industry experts) may actually not raise it as an issue (although some will certainly do, particularly in other European countries where the nature of partnerships as a legal form and the way it is used in private equity are not very well understood), but technically you should be presenting it as a liability. Remember that if capital/loan contributions are presented as liability, though, this would require presenting subscriptions and redemptions (understand drawdowns and distributions in the context of a private equity fund organised as a limited partnership) rather as changes in that liability; with distinguishing between distributions of cost and distributions of income/

gains; and the different presentation with income/gains distributions recognised in the income statement and the cost distribution recognised simply as changes in liability.

If you want to see a more by-the-book presentation, please refer to *PwC Illustrative IFRS Financial Statements for Private Equity 2009* (or later edition).

Figure 15.2: **Sample statement of financial position under IFRS**

Statement of financial position* at December 31, 2010

(All figures stated in £) 2009

Assets	
Non-current assets	
Financial assets at fair value	95,500,000
Total non-current assets	95,500,000
Current assets	
Drawdown receivables	-
Other receivables and prepaids	150,000
Cash and cash equivalents	350,000
Total current assets	500,000
Total assets	96,000,000
Liabilities	
Current liabilities	
Other payables and accrued liabilities	(1,000,000)
Total current liabilities	(1,000,000)
Total liabilities**	(1,000,000)
Net assets attributable to partners	95,000,000
Represented by: ***	
Capital contributions	10,000
Loan contributions	82,090,000
Income account	12,900,000
Total attributable to partners	95,000,000

* IAS 1 now refers to the balance sheet as 'statement of financial position' with an optional application of the new title.

*** Total liabilities consists only of current liabilities as there are no non-current liabilities.

*** Although this presentation rather suggests a treatment of the partners' capital as equity, it is still more traditional in the UK as it better reflects the LPA. Probably the best way of presenting it, so that it is still IFRS, is to show the loan as a liability in the balance sheet, but then at the foot of the balance sheet, combine all the partners interests. Refer to PwC Illustrative IFRS Financial Statements 2009 Private Equity for a more by-the-book presentation.

Statement of changes in: equity/partners' capital/net assets attributable to the partners

IAS 1 refers to this component of the financial statements as “statement of changes in equity”, but in practice you will probably more often come across one called a ‘statement of changes in partners’ capital’ or ‘statement of changes in net assets attributable to the partners’ (the latter used by PwC in its Illustrative financial statements for private equity mentioned earlier). Again, do not forget that the names of the statements used in the standard are not mandatory and you may come up with a more appropriate title.

What are changes in equity and why the users of financial statements need that information?

Changes in equity between the beginning and the end of the reporting period reflect the increase or decrease in its net assets during the period and that is why some prefer to use the ‘statement of changes in net assets’ title instead of ‘statement of changes in equity’. Generally, the overall change in equity during a period represents the total amount of income and expense, including gains and losses, generated by the entity’s activities during that period, except for changes resulting from transactions with owners in their capacity as owners.

Under IFRS, a statement of changes in equity is required if the entity has equity. However, as discussed previously, contributions should typically be classified as liabilities (at least loan contributions in a typical UK partnership, with only the 0.001 percent capital contributions probably classified as equity), therefore there would be no (or a very small amount of) equity, unless you prefer the alternative not-quite-IFRS presentation from [Figure 15.2](#). For a partnership with no equity, the statement of changes in equity is not required, but the best practice is to present a statement of changes in net assets attributable to holders of redeemable shares or interest (and then that would cover what otherwise would have not been presented as changes in equity).

If you are preparing a statement of changes in equity, what information needs to go into it is defined in paragraph 106 of IAS 1 – this requires that the statement of changes in equity includes the following information:

- Total comprehensive income for the period.
- For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period separately disclosing changes resulting from profit or loss.
- For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period separately disclosing changes resulting from other comprehensive

income. In addition, for each component of equity, either in the statement of changes in equity or in the notes, an analysis of other comprehensive income by item.

- For each component of equity, reconciliation between the carrying amount at the beginning and the end of the period separately disclosing changes resulting from transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners.

- For each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with *IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors*. Retrospective adjustments and retrospective restatements are not changes in equity but they are adjustments to the opening balance of retained earnings, except when an IFRS requires retrospective adjustment of another component of equity. Paragraph 106(b) of IAS 1 requires disclosure in the statement of changes in equity of the total adjustment to each component of equity resulting from changes in accounting policies and, separately, from corrections of errors. These adjustments are disclosed for each prior period and the beginning of the period.⁵

With reference to paragraph 108, equity components include, for example, each class of contributed equity, the accumulated balance of each class of other comprehensive income and retained earnings. In the context of a private equity fund, this needs to be done by class of partners (LPs and GP and the FP, if one exits).

In line with the general provisions of the standards, as discussed above, comparative numbers need to be provided.

The presentation of [Figure 15.3](#) is consistent with the presentation in [Figure 15.2](#), in that, as explained earlier, it rather suggests a treatment of the partners' capital as equity, which is still the preferred presentation in the UK as it better reflects the LPA. For the relevant by-the-book presentation, refer to *PwC Illustrative IFRS Financial Statements for Private Equity 2009* (or a later version). Again, you can chose one of them or you can come up with a completely different one that better/clearer discloses the information required by the standard, in the context of your activities, and the same applies to the title of that statement, particularly with regards to the equity-versus-liability issue.

Statement of cash flows

Under IFRS, statement of cash flows is required for all entities

including for investment partnerships and there are no exceptions. The requirements are set out in *IAS 7 Statement of Cash Flows*. Unlike other statements, *IAS 7 Statement of Cash Flows* requires standard headings, paragraph 10 of the same standard requires that cash flows are classified by operating, investing and financing activities, but there is limited guidance on what should be included under each of these headings.

The statement of cash flows for a private equity fund is rarely a challenge compared to one for a manufacturing company, for example, with its many non-cash adjustments (such as depreciation adjustment). However, you should be careful because very often the statement is overlooked. In fact, I have even seen incorrect statements of cash flows which have even been audited.

Either the direct or indirect method can be used for cash flows from operating activities. IFRS encourages the use of the direct method, but in practice, investment partnerships typically apply the indirect method traditionally used in Anglo-Saxon countries such as the UK, while elsewhere in Europe some investment entities may give preference to the direct method traditionally across the regions.

Figure 15.3: Sample statement of changes in partners' capital (more traditional presentation)

Statement of changes in partners' capital* for the year ended December 31, 2010 (All figures stated in £ thousands)		Carrying amount
At January 1, 2010		95,000,000
Capital contributions		-
Drawdowns from partners		79,900,000
Distributions to partners		(70,000,000)
Total comprehensive income		23,100,000
At December 31, 2010		128,000,000
For the year ended December 31, 2009 (All figures stated in £ thousands)		Carrying amount
At January 1, 2009		-
Capital contributions		10,000
Drawdowns from partners		82,090,000
Distributions to partners		-
Total comprehensive income		12,900,000
At December 31, 2009		95,000,000

* This presentation is consistent with the statement of financial position presented in [Figure 15.2](#) suggesting a treatment for the partners' capital rather as equity which is not a strictly IFRS treatments as explained in [Chapter 7](#) and in this chapter. Refer to PwC Illustrative IFRS Financial Statements 2009 Private Equity for a more by-the-book presentation. A number of other presentations with more detailed information exist in practice with the most popular one presented by class of partners (LPs, GP and CIP).

Definition of cash and cash equivalents

Cash and cash equivalents, which include cash or cash investments with maturities of three months or less from the date of acquisition, may include bank overdrafts if they are used as part of the investment entity's cash management.

Figure 15.4 presents an example of a statement of cash flows prepared under the indirect method, although IFRS recommends the direct method, which you will probably see more often in European (except for UK) private equity funds, as explained earlier. For an example of a statement of cash flows prepared using the direct method, please refer to the example provided in *PwC IFRS Illustrative Financial Statements for Private Equity 2009* (or later versions).

Figure 15.4: Sample statement of cash flows under IFRS	
Statement of cash flows* for the year ended December 31, 2010	
(All figures stated in £) 2009	
Cash flow from operating	12,900,000
Adjusted for:	
Net realised gains on finan	-
Net changes in fair value o	(13,500,000)
(Increase) in receivables	(150,000)
Increase/(decrease) in pay	1,000,000
Net cash inflow/(outflow)	250,000
Cash flow from investing activities	
Purchase of investments	(82,000,000)
Disposal of investments	-
Net cash outflow from in	(82,000,000)
Cash flow from financing activities	
82,000,000 from partners	
Distributions to partners	-
Net cash inflow from fina	82,100,000
Net (decrease)/increase i	350,000
Cash and cash equivalents	-
Cash and cash equivalen	350,000

* The indirect method is used for the preparation of the Statement of Cash Flows, although IFRS recommends the direct method.

Similar to other statements, you can use a different title for the statement; for example you can use the former title 'cash-flow statement' instead of the one suggested by the standard title 'statement of cash flows'. Alternatively, you can use different caption that better reflects the nature of your activities.

Notes to the financial statements

The notes to the financial statement are diverse and they satisfy disclosure requirements of a number of standards. In addition, they

may provide additional information that is not required by the standards, but is deemed to be useful by the GP to be useful to investors, or required by some investors and possibly required by regulation (where applicable).

The most important standards requiring disclosures for a private equity fund that you need to look into detail are *IFRS 7 Financial Instruments: Disclosures* and *IAS 39 Financial Instruments: Recognition and Measurement* that will be replaced in the future by *IFRS 9 Financial Instruments*, as discussed in **Chapter 9**) considering the activities of a private equity fund, but of course all other IFRS general standards relevant to the activities of the fund are applicable, for example the discussed in detail in this chapter *IAS 1 Presentation of Financial Statements*, *IAS 21 The Effects of Changes in Foreign Exchange Rates*, *IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors*, *IAS 10 Events after the Reporting Period*, *IAS 24 Related Party Disclosures* and other applicable standards, and let us not forget the consolidations standards (*IAS 27 Consolidated and Separate Financial Statements* and *IAS 28 Investments in Associates* or the new replacement standards when they become effective *IFRS 10 Consolidated Financial Statements*, *IFRS 11 Joint Arrangements* and *IFRS 12 Disclosure of Interest in Other Entities*) if you consolidate as the current standards require, but if you do not want to consolidate a departure with regards to consolidation needs to be disclosed with a mentioning of the reasons or use the future consolidation exemption for investment entities when effective.

Investments schedule

Unlike US GAAP which provides industry-specific guidance, IFRS does not have such specific requirements for the presentation of the investments schedule, although IFRS 7 prescribes certain disclosures, as discussed in **Chapter 9**, with the investments schedule not being a part of the primary statements, just a note to the financial statements.

UK GAAP

For those of you who are unfamiliar with the Generally Accepted Accounting Principles in the UK (UK GAAP) they are much-used, but still undefined, with the components of UK GAAP varying depending on the type of entity preparing the accounts. According to the *PwC UK GAAP Manual of Accounting* these components, for a non-listed company, are divided into mandatory elements and authoritative (but non-mandatory) elements:

- Mandatory (in law or in practice) elements, comprising the following:
 - ◆The Companies Act 2006.
 - ◆Accounting standards – Financial Reporting Standards (FRSs) and Statements of Standards Accounting Practice (SSAPs) issued by the Accounting Standards Board (ASB).
 - ◆Abstracts issued by the ASB's Urgent Issues Task Force (UITF).
- Authoritative (to varying degrees) but non-mandatory elements:
 - ◆The ASB's Statement of Principles for financial reporting.
 - ◆Other ASB's statements.
 - ◆Statements and recommendations from the professional bodies (such as ICAEW's technical releases and recommendations).
 - ◆Statements of recommended practice (SORPs) issued for specific sectors.
 - ◆Generally accepted/established practice (for example, guidance from leading accounting firms, such as the *PwC Manual of Accounting*)

UK GAAP is potentially confusing for someone used to a more prescriptive accounting framework, but UK GAAP allows some options, and although having options is generally good, sometimes it makes things more confusing as, for example, which standards you need to apply if you go for one or the other option. Following is a discussion of the options.

UK GAAP with FRS 26 adoption (new UK GAAP)

As explained in [Chapter 9](#), there is a choice in UK GAAP between preparing your accounts on either a historical cost basis and on a fair-value basis. Those who choose the fair-value option basically apply a package of standards: (*FRS 26 (IAS 39) Financial Instruments: Recognition and Measurement*; *FRS 25 (IAS 32) Financial Instruments*/*FRS 29 (IFRS 7) Financial Instruments: Disclosures*; *FRS 23 (IAS 21) The Effects of Changes in Foreign Exchange Rates* and *FRS 24 (IAS 29) Financial Reporting in Hyperinflationary Economies*, which is called new UK GAAP, although now there is an even newer UK GAAP as explained below). For the funds that have adopted this package of standards, the treatment is similar to IFRS, as these FRSs are virtually the relevant IASs/IFRSs in the brackets with very minor changes done by the ASB.

Old UK GAAP

As explained in [Chapter 9](#), this is an option available to entities that still want to apply the historical-cost convention; those entities do not need to adopt FRS 26. For more information refer to [Chapter 9](#).

LPA GAAP

LPA GAAP or investor-defined accounting framework is still available as an option – although this may change in the future – to non-qualifying partnerships. If you opt for it you will be able to choose flexible accounting rules that are generally acceptable or a typical, LPA would typically refer to these as 'generally accepted accounting principles as agreed from time to time with the auditors'. Many UK private equity funds do choose this option.

The future of UK GAAP – IFRS for SMEs

A brief mention about the future of UK GAAP: the UK ASB has proposed a new three-tier system of reporting depending on the 'public accountability' of the reporting entity. What are the three tiers proposed?

- Tier 1 – EU-adopted IFRS (for publicly accountable companies).
- Tier 2 – IFRS for SMEs (small-and-medium-sized entities) (for companies that are not publicly accountable).
- Tier 3 – The UK's Financial Reporting Standard for Smaller Entities (FRSSE) (for companies that qualify).

In summary, most UK companies will have to report under either EU-adopted IFRS (IFRS or 'full IFRS') or IFRS for SMEs, based on whether the entity is 'publicly accountable' (see definition below). FRSSE will still be an option for qualifying companies. But what is 'publicly accountable' and would UK private equity funds organised as limited partnerships fall within that definition?

Under the definition proposed by ASB, which is the definition used by IFRS for SMEs, an entity is publicly accountable if:

- the entity's debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or
- the entity holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case

for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.

The changes apply to all entities that apply UK GAAP, and obviously, a private equity fund organised as a limited partnership would not fall under the first condition, but would it fall under the second one? The answer to that question is not straightforward and I will leave it open to be discussed in future publications, as the point of this paragraph is really just that you are aware of that development. Now that you are more familiar with UK GAAP, the options available and its future, the following focuses on the format of the financial statements under UK GAAP, ignoring the future and the fact that some UK funds would opt for either LPA GAAP or IFRS (either full or with some departure, for example for consolidation).

Format of UK GAAP financial statements

The first question an accountant who has never prepared accounts under UK GAAP would ask is about where the format of the financial statements under UK GAAP is defined. The following discussion provides some guidance.

Qualifying and non-qualifying partnerships

First, you need to be clear on whether or not the partnership you are preparing accounts for is a qualifying or a non-qualifying partnership.

To prepare accounts for a qualifying partnership, including a limited partnership, *The Partnerships (Accounts) Regulations 2008* is applicable; a qualifying partnership is defined in regulation 3 of this set of regulations. Most UK-based private equity funds are structured as non-qualifying partnerships so that they can avoid filing their accounts with Companies House in the UK. Otherwise, this would mean that their accounts would be publicly available, which is undesirable from a GP perspective. That is the very reason why most UK private equity funds are able to use LPA GAAP. The definition of a qualifying partnership is under review as of October 2011 (it has been for a while), as the definition is considered to be incorrectly interpreted from an EU directive.

In the future this may change, resulting in more partnerships falling within that definition, unless they restructure. I do not intend to discuss what the qualifying partnership definition is or the progress of any new definitions being implemented. Instead, I would like to point out that with reference to regulation 4 of *The Partnerships (Accounts)*

Regulations 2008, qualifying partnerships need to prepare accounts as if the partnership were a company under Part 15 (accounts and reports); [Chapter 1](#) of Part 16 (requirement for audited accounts) of the Companies Act 2006; *The Small Companies (Accounts) Regulations 2008* (abbreviated accounts); or *The Large-and Medium-sized Companies (Accounts and Report) Regulations 2008* (full accounts), as the case may be.⁶

Assuming that a private equity fund established as a UK limited partnership decides to apply UK GAAP, instead of LPA GAAP and full accounts instead of abbreviated small-company accounts, then the format for those accounts is set out in Schedule 1 of *The Large-and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* for non-consolidating entities or Schedule 6 of the same regulations for consolidated entities. If this option is made, a UK GAAP set of accounts/financial statements would include the following four primary statements:

- Balance sheet (Companies Act 2006, Sec 396(1)(2)).
- Profit & loss account (Companies Act 2006, Sec 396(1)(2)).
- Statement of total recognised gains (FRS 3 *Reporting Financial Performance*, paragraph 27, not the Companies Act 2006).
- Cash-flow statement (FRS 1 *Cash Flow Statements*, paragraph 4, not the Companies Act 2006).

Schedule 1 of *The Large-and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008* allows two alternative formats for the balance sheet and four alternative formats for the profit & loss account.

The formats of UK GAAP consolidated financial statements are substantially similar to those of individual financial statements and they have to comply as far as practicable with the provisions of Schedule 1 mentioned above and Schedule 6 to define their form and content. In addition to the four primary statements for the individual companies (but consolidated), they need to prepare the parent's individual balance sheet and related notes. The subject of consolidation is discussed in detail in [Chapter 17](#).

Most UK non-qualifying partnerships tend to prepare accounts under LPA GAAP since that option broadly follows a modified version of the UK GAAP format.

US GAAP

Probably the first thing to note is that, unlike IFRS and UK GAAP, where comparative information is imperative, under US GAAP, comparative financial statements are not required for investment companies.

A set of US GAAP financial statements generally includes the following:

- Statement of assets and liabilities or a statement of net assets (with a schedule of investment therein, discussed and presented in [Chapter 9](#), see [Figure 9.2](#)).
- Statement of operations.
- Statement of changes in net assets.
- Statement of cash flows (if required).
- Notes to the financial statements.

I have decided not to include sample statements, similar to the IFRS examples, as information on financial statements for private equity funds under US GAAP is more readily available compared with samples under IFRS or UK GAAP. The best example, in my opinion, is the *ILPA Quarterly Reporting Standards Best Practices* template, which was released in late October 2011 following ILPA's review of comments from constituents on the version released in August 2011.

Statement of assets and liabilities/statement of net assets

The statement of assets and liabilities has a non-classified presentation and has requirements for the presentation of specific items with the investments presented first due to their importance considering the nature of an investment company. The schedule of investments could be presented either on the face of the statement of assets and liabilities or as a separate schedule, as discussed in more detail in [Chapter 9](#) with a sample presented in [Figure 9.2](#).

Classification of capital contributions

Under US GAAP, all financial instruments, including issued equity (capital contributions in the context of a private equity fund), require evaluation under *FASB ASC 480 Distinguishing Liabilities from Equity* for potential liability classification. They should be classified as liabilities if they are unconditionally redeemable by transferring assets at a specified or determinable date (or dates) or when an event is certain to occur (or generally on fixed dates) for amounts that are

either fixed or determined by reference to an interest rate index, currency index or another external index. For all other mandatorily redeemable financial instruments the classification, measurement and disclosure provisions of FASB ASC 480 are deferred indefinitely pending further action by the FASB.

Therefore, unlike IFRS, capital contributions (for avoidance of doubt, capital contributions in a US fund would typically include what in a UK fund is structured as both capital and loan contributions) are typically classified as equity, because the amounts to be paid are not fixed or determinable and the dates are not fixed. Therefore, they meet the deferral criteria, unlike IFRS whereby the definition of liabilities is different, and as previously discussed, contributions (except for the 0.001 percent capital contributions for UK partnerships) are typically classified as liabilities.⁷

If capital contributions (partners' interests) are classified as equity, then distributions to LPs should be recognised as transactions in equity and presented on the statement of changes in net assets.

Net-assets measurement: the net-assets measurement is similar to IFRS, that is, the residual value of the assets net of liabilities.

Statement of operations

US GAAP requires specific items to be presented and disclosed on the face of the statement of operations. Remember that IFRS does not prescribe a standard format for the statement of comprehensive income/income statement.

Realised and unrealised gains (losses) on investments

As discussed in **Chapter 9**, and unlike for IFRS, net realised gains (losses) and net change in unrealised appreciation (depreciation) should be disclosed separately.

Realised and unrealised gains or losses on foreign currency transactions also need to be distinguished.

The foreign currency element of gains or losses on investments may be presented either separately or together with the local-currency market gains or losses on investments.

The rules permit either separate or combined reporting of net unrealised gains or losses from investments with net unrealised gains or losses from foreign currency transactions. The same applies to net

realised gains (losses) from investments and net realised gains (losses) from foreign currency transactions and they may be reported either separately or may be combined.

Therefore, in drawing a simple conclusion, under US GAAP, compared with IFRS, the distinction between realised and unrealised gains (losses) is more important, while the distinction between net realised and unrealised gains (losses) from investments and net realised and unrealised gains (losses) from foreign currency transactions not so much so and there is an element of choice in the presentation – separately or combined.

In addition, there is a requirement for separating interest income (on investments) from fair-value movements.

At present (before the amendments discussed above in the IFRS section are effective), US GAAP and IFRSs differ on the presentation of OCI items. US GAAP does not require OCI items to be presented in the statement of comprehensive income, but allows them to be incorporated in the statement of changes in equity or in the notes. This makes it difficult to identify and understand the nature of those gains and losses. These different approaches also make it difficult for users to compare financial statements prepared in accordance with US GAAP and those prepared in accordance with IFRSs.

FASB has amended US GAAP to require profit or loss and other comprehensive income to be presented in either one statement or two continuous statements, with profit or loss items presented separately. The changes to IAS 1 and US GAAP will make it easier for users to compare the financial statements prepared in accordance with US GAAP with those prepared in accordance with IFRSs.⁸

Statement of changes: in net assets/in equity

Unlike IFRS which does not prescribe a specific format, under US GAAP specific items are required to be presented and disclosed on the face of the statement of changes in net assets/statement of changes in equity as the increase and decrease in net assets.

These items are:

- net changes in net assets resulting from operations;
- net equalisation debits and credits;
- distributions to partners;
- capital-share transactions for each class, which can be presented

- either in the statement itself or in the notes; and
- capital contributions.

For private equity funds organised as limited partnerships, the statement of changes in net assets/equity may be combined with the statement of changes in partners' capital.

Statement of cash flows

Similar to IFRS, there are standard headings required under US GAAP, but unlike under IFRS, specific guidance for items included in each category is provided. Also similar to IFRS, either the direct or indirect method can be used for cash flows from operating activities, but unlike IFRS, preference is given to (and in practice is more commonly used which is similar to the UK application of IFRS) the indirect method.

If certain conditions are met, however, an investment company may be exempted from presenting a statement of cash flows which is another difference to IFRS where all entities prepare the statement of cash flows.

Definition of cash and cash equivalents

As with IFRS, only investments with original maturities of three months or less qualify for cash equivalents; movements in bank overdrafts should be shown as financing activities though.

Notes to the financial statements

The notes to the financial statements under US GAAP cover a vast topic that would need a whole separate publication to do them justice, as even if I were only scratch the surface of limited amount, I would only leave more questions unanswered. However, one note that I feel that I need to mention, without an equivalent under IFRS and UK GAAP, is the mandatory financial highlights that is a very important part of the disclosures and include useful information such IRRs and a number of ratios such as operating expenses to (average) net assets.

ILPA standardised format

As mentioned in [Chapter 7](#) and [Chapter 13](#), ILPA released the Quarterly Reporting Standards Best Practices that include a standardised template of a quarterly report (including a set of financial

statements appended at the back of the report), which is the latest of ILPA's standardised best-practice templates, which will be very useful. I would strongly recommend that you check ILPA document and benchmark your quarterly reports (including the financial statements appended at the back taking into consideration the specific GAAP your financial statements are prepared under) against it, as that is probably what your LPs would expect in the future.

Summary

In this chapter, I have discussed the final product resulting from the fund accounting team's hard work – fund financial statements. I have explained why they are different from the financial statements of other non-investment and investment entities and what different formats there are under the main recognised accounting frameworks (IFRS, UK GAAP and US GAAP) with some of their specifics and issues, as well some similarities and differences. I have also presented some of the main primary statements under some of the main recognised accounting frameworks (IFRS and US GAAP) with some alternative presentations (where available) as well as some controversial issues.

Now that I have covered most of the accounting areas in private equity accounting, in the next five chapters my expert contributors will elaborate on some areas which are of particular interest to fund accountants. They will demonstrate different (from mine) points of view on topics that I am sure will be of interest to you. They all have an extensive experience within the industry and are all experts in their own right. The topics they have contributed expert thought on comprise allocations, consolidation, performance measurement, investor reporting and investor relations, and private equity accounting through the eyes of the auditors. In **Chapter 10** another expert contributor writes about valuations, an area which is not strictly about accounting but its outcome is used in accounting. I am confident that you will not only find their opinions very useful, but will thoroughly enjoy reading them.

¹ IAS 1. Presentation of Financial Statements, edition 01/01/2011, IFRS Foundation.

² Presentation of Items of Other Comprehensive Income: Amendments to IAS 1: Project Summary and Feedback Statement, IFRS Foundation, June 2011.

³ Presentation of Items of Other Comprehensive Income: Amendments to IAS 1: Project Summary and Feedback Statement, IFRS Foundation, June 2011.

⁴ IAS 1. Presentation of Financial Statements, edition 01/01/2011, IFRS Foundation.

⁵ IAS 1. Presentation of Financial Statements, edition 01/01/2011, IFRS Foundation.

⁶ The UK Partnerships (Accounts) Regulations 2008.

⁷ PwC Similarities and Differences: a Comparison of US GAAP and IFRS for Investment Companies, PricewaterhouseCoopers, February 2011.

⁸ Presentation of Items of Other Comprehensive Income: Amendments to IAS 1: Project Summary and Feedback Statement, IFRS Foundation, June 2011.

More about allocations

By Gaurav Marwah, Augentius Fund Administration LLP

This chapter discusses:

- The reason and importance of allocating assets, liabilities and profits and losses to individual investors
- Partners' account structure
- Different allocation rules:
 - ◆by commitment
 - ◆by remaining commitment
 - ◆by drawn commitment
 - ◆some specific allocation rules
- Some other important considerations:
 - ◆defaulting partners
 - ◆partner transfers
 - ◆allocations at the carried interest partner level
 - ◆allocations at the general partner level

Introduction

Allocations form a crucial part of limited partnership accounting or for that matter any form of partnership accounting and are an integral part of any limited partnership agreement (LPA). The underlying essence of partnership accounting is about how the underlying net assets/profits and losses will be allocated between various partners based on their agreed sharing percentages. Generally, as partnerships are tax-transparent and it is the partners who are taxed on their share of profits and distributions allocated from the partnership, allocations thereby form not just a crucial part of partnership accounting but also drive tax computations of individual partners.

All net income or loss and capital gains or losses are allocated between various partners in accordance with the LPA. The LPA clauses dictate how partnership profits and/or losses are allocated and the ratio in which the partners share profits and/or losses. The allocations clauses in any LPA are crucial as these will determine each partner's entitlement to a share of profits and/or losses and will dictate how the partners will be taxed.

These clauses are important not only from the limited partner (LP) perspective but also from carried interest partner (CIP) perspective as these will dictate how the partnership profits (that is, net income and capital gains) will be shared between the LPs and the CIP when the latter becomes entitled to its share of the overall partnership profits (that is, its carried interest) and accordingly dictate the adjustments to be made between the CIP and LPs at each carry point.

The various parties associated with allocations for a private equity limited partnership will depend on different factors as explained in detail in [Chapter 2](#) and [Appendix I](#). As a minimum there will be a general partner (GP) and LPs or investors. In such a structure the GP will usually receive the management fee/GP share/priority profit share (PPS) (which could also be paid directly to an investment manager) and will be entitled to receive the carried interest. In UK partnerships, there will generally be a separate CIP or founder partner (FP), which will contribute a small capital contribution in proportion to its carry entitlement.

Partners' accounts structure

UK LP format: A UK limited partnership will generally follow the following partner account format (discussed in more detail in [Chapter 4](#)):

- Capital-contributions account – all the initial capital contributions and repayments thereof will be credited or debited to this account, respectively.
- Loan account (applicable to UK funds) – all the loan contributions and repayments thereof (loan distributions) will be credited or debited to this account, respectively.
- Income account – all the net income and/or losses (except capital gains or losses) and distributions thereof (except for repayment of loan) will be credited or debited to this account, respectively.
- Capital account – all capital gains and/or losses and distributions thereof (except for repayment of loan) will be credited or debited to

this account, respectively.

There is another similar format which is commonly used for other non-UK funds whereby there is a capital-commitment/-contributions account, an income account and capital account with same characteristics as listed above. There is no loan account as this is predominantly a UK concept, that is, the commitment being split between capital contribution and loan commitment.

However, it is usually more practical to keep the distributions separate from these accounts into a separate account and also combining the income and capital account into one account. Only accounting profits will then be posted to the combined income and capital account and cash distributions to be kept separate for clarity and ease of reconciliation.

US LP format: A US limited partnership will generally just have one partner account, namely the capital account, and all transactions are debited and credited to the capital account.

Various items to be allocated in a limited partnership

GP share/management profit share/PPS

As discussed in [Chapter 12](#), the fees paid to the GP can be structured in different ways. If structured as management fees they will be expensed whereas if the fees are structured as the GP share then they will be treated as allocation of profits to the GP. Regardless of how the sharing percentages have been laid out in the partnership agreement, the GP share (discussed in detail in [Chapter 12](#)) will always rank as the first charge on profits of the limited partnership. There are usually two different options available for allocation of profits to the GP. In the first option the GP will have to allocate net income first on account of the GPS and thereafter only any capital gains available if net income was insufficient. In the second option the GP will have the priority about which items of net income and capital gains it chooses to allocate itself on account of the GP share. However, usually under the second option there are restrictive clauses attached whereby such election by the GP should not result in tax disadvantages for the LPs. The application will depend on which one of the two specific clauses has been set out in the relevant LPA under consideration. The GP will only pick up any profits in the process and will not allocate any losses specifically, but only net income and net capital gains are allocated, that is, after offsetting any expenses and capital losses.

Profits and losses

All profits and losses remaining after allocation of the GP share are allocated between the LPs based on the allocation rules/sharing percentages as set out in the LPA which is generally in line with how various items are funded by the LPs. The allocations under this section will depend on the fund's structure.

Investments

Investment costs are usually allocated between partners on the basis of amounts funded by the partners through the drawdowns. Investments, profits and losses are generally allocated between partners in the same way and in line with the partners' fundings. However, there are certain partnerships which have specific terms for funding of different investments within the fund and are allocated using specific deal-allocation criteria set out by the manager and the corresponding profits and losses from these investments are also allocated using the specific deal-allocation criteria. These have been discussed in more detail in the allocation rules section of the chapter.

Other assets and liabilities

These will be allocated in the same way as the profits and losses as these will usually be the corresponding sides of profits and losses transactions.

CIP/FP structures

In a typical UK partnership structure where there is a CIP/FP introduced as a separate entity in the partnership for the purpose of receiving the carried interest, the profits are allocated between the LPs and FP on the basis of their capital contributions which is usually 80:20 in most cases. In such FP structures, there are three stages of allocations:

- 1.Pre-carry allocations: until the fund reaches the carry stage, all profits and losses are allocated between the partners not based on capital contributions but on the other set out allocation criteria within the LPA, that is, proportionately based on commitments or remaining commitments or drawn commitments (some of these common allocation rules/criteria are discussed further in the chapter).
- 2.At the point of carry and thereon (after the fund is in carry): at the point when fund reaches carry, the allocations are reverted back as being on capital contributions between the FP and the LPs with retrospective effect, that is, all historic profits and losses allocated

to partners based on the alternative allocation criteria are also now allocated based on capital contributions as is these were always allocated on capital contributions basis and adjustments are made between the FP and LPs accordingly.

If there are further drawdowns from partners subsequent to getting into carry, the allocations are generally reverted back to the other set out allocation criteria as mentioned above under pre-carry allocations. On reaching the next carry point, the allocations will be reverted back to capital contributions including any interim period between the two carry points whereby the transactions were allocated on the other set out allocation criteria.

3. At termination/liquidation: at the end of the life of the fund, the key principle in relation to allocations will be that allocations for each partner should equal the distributions made to them over the life of the fund and in case of any differences adjustments will be made between partners' accounts to eliminate such differences and to ensure that all allocations equal distributions. However, certain GPs at times may decide to override the allocation criteria during the life of the fund as well and work on the basis of distribution criteria and allocate only such profits to the FP as they fall to be distributed. In making such a decision GPs should consult their auditors and the tax advisers to ensure that the approach will not put the LPs at a tax disadvantage during the life of the fund.

Having mentioned the different stages of the allocations, there could be LPAs in which the allocations clauses refer to the distribution section and all allocations are then carried out in accordance with the clauses set out in the distribution section. This will generally be done to simplify the allocations as no adjustments will then be needed to align the allocations and distributions at the end of the life of the fund.

Standard allocation criteria and rules

1. Allocations based on commitment

This is one of the most commonly used and simplest allocation rules in a private equity limited partnership. As the name suggests, all profits and losses, investments and relevant balance sheet items are allocated to each partner *pro rata* based on the proportion of their individual commitment to the total commitment of the fund. The drawdowns are funded by all partners based on their proportionate commitments.

Investment

100000

£000s

Investor A	500
Investor B	300
Investor C	200
Total	1,000

* Fund draws down £1 million for an investment

** £100,000 investment income received during the year

*** £50,000 total expenses incurred during the year

Source: Author

Table 16.1 shows a simple illustration of how various items will be allocated across different partners based on their proportion of commitment to the overall commitment of the fund. For example, Investor A has sharing percentage of 50 percent, which is its individual commitment of £5 million as a proportion of total fund commitment of £10 million.

Table 16.2: Allocations based on remaining commitments

	Commitment	Commitment %	Drawdown 1 Investment	Drawdown 1, 2, 3 (share)	Remaining commitment after 2017	Investment 1*	Drawdown 2**	Investment 2**	Remaining commitment after 2017	Drawdown 2***	Investment 1 Follow-on***	Remaining commitment after 2017	Income****	Expenses*****
	£000s	%	£000s	£000s	£000s	£000s	£000s	£000s	£000s	£000s	£000s	£000s	£000s	£000s
Investor A	5,000	45%	455	50	4,495	455	454	454	4,041	455	455	3,587	76	23
Investor B	3,000	27%	273	30	2,697	273	272	272	2,425	273	273	2,152	27	13
Investor C	2,000	18%	182	20	1,795	182	182	182	1,616	182	182	1,435	18	9
GP/GP Commitment	1,000	9%	90		910	90	92	92	818	90	90	728	9	5
Total	11,000	100%	1,000	100	9,900	1,000	1,000	1,000	8,900	1,000	1,000	7,900	100	50

* Fund draws down £1 million for investment and £100,000 for the GP share

** Fund draws down another £1 million for a second investment

*** Fund draws down another £1 million for follow-on investment in Investment 1

**** £100,000 investment income received at the end of the year from Investment 2

***** £50,000 total expenses incurred at the end of the year

Source: Author

2. Allocations based on remaining commitment

As the name suggests, various items are allocated between partners based on remaining commitment of the partners, that is, allocated to

each partner *pro rata* based on specific remaining commitment of that partner as a proportion of the total fund remaining commitment. This is generally used where there are variations or certain exceptions for funding/drawdowns from different partners, the most common example of which would be where there is a commitment from the GP or the FP and they would not be bearing a share of the GP share or where there are expected to be excused investors. In that case the remaining commitment allocation rule will give different result compared to a commitment based allocation rule which is illustrated in [Table 16.2](#).

[Table 16.2](#) illustrates a simple example where various drawdowns, investments and income/expenses have been allocated based on remaining commitments. For example, Investor A has been allocated Drawdown 2 based on its proportion of remaining commitment, that is, £4,495,000/£9.9 million. As the FP/GP does not share the GP share, the remaining commitment proportion and commitment proportion for all partners becomes different after the GP share is drawn.

However, an important thing to note is that while all items are to be allocated on remaining commitment percentage basis but if there are any drawdowns for follow-on investment and for any income generated from a specific investment, the original investment allocation proportion will be used regardless of how the remaining commitment would have changed over time; thus, making it a combination allocation rule of investment-specific and remaining commitment allocations.

3.Allocations based on drawn commitment

The allocations under this allocation rule are based on drawn commitments from partners or in other words amounts contributed to the allocation date of the item.

As in the case of the allocations based on remaining commitment criteria, this is generally used where there are variations or certain exceptions for funding/drawdowns from different partners, the most common example of which would be where there is a commitment from the GP or the FP and they would not be bearing a share of the GP share or where there are expected to be excused investors. In this case the drawn commitment allocation rule will give different result compared to a commitment-based allocation rule, which is illustrated in [Table 16.3](#).

[Table 16.3](#) illustrates a simple example whereby various drawdowns, investments and income/expenses have been allocated based on drawn commitments. For example, Investor A has been allocated

Drawdown 2 based on its proportion of drawn commitment, that is, £505,000 out of £1.1 million. As the FP/GP does not share the GP share, the drawn commitment proportion and commitment proportion for all partners becomes different after GPS is drawn.

Table 16.3: Allocations based on drawn commitment

	Commitment	Commitment %	Drawdown 1 (GP share) [*]	Drawdown 1 (GP share) [*]	Drawn commitment (after DD 1)	Investment 1 ^{**}	Drawdown 2 ^{**}	Investment 2 ^{**}	Drawn commitment (after DD 2)	Drawdown 3 ^{***}	Investment 1 follow-on ^{***}	Drawn commitment (after DD 3)	Investment 3 ^{****}	Expenses ^{*****}
	1000s	%	1000s	1000s	1000s	1000s	1000s	1000s	1000s	1000s	1000s	1000s	1000s	1000s
Investor A	5,000	48%	455	50	505	455	459	459	964	455	455	1,419	45	23
Investor B	3,000	27%	273	30	303	273	275	275	578	273	273	851	28	14
Investor C	2,000	18%	182	20	202	182	183	183	387	182	182	567	18	9
GP's GP commitment	1,000	9%	90	-	90	90	83	83	173	90	90	263	8	4
Total	11,000	100%	1,000	100	1,100	1,000	1,000	1,000	2,100	1,000	1,000	3,100	100	50

* Fund draws down £1 million for investments and £100,000 for the GP share

** Fund draws down another £1 million for a second investment

*** Fund draws down another £1 million for follow-on investment in Investment 1

**** £100,000 investment income received at end of the year from Investment 2

***** £50,000 total expenses incurred at the end of the year

Source: Author

However, an important thing to note (as in case of remaining commitment) is that while all items are to be allocated on drawn-commitment-percentage basis, but if there are any drawdowns for follow-on investment and for any income generated from a specific investment, the original investment allocation proportion will be used regardless of how the drawn commitment would have changed over time; thus making it a combination allocation rule of investment specific and drawn commitment allocations.

4. Specific allocations

There could be certain situations whereby the fund will draw down and invest funds from partners based on specific allocations. This could be due to various reasons: mainly because there could be excused investors from certain type/geography of investment; the fund could have made substantial gain or loss on certain investment(s) before a subsequent closing and in such situations the manager will decide to not allocate the investment and/or the fair value gain and loss to the

subsequent investors thereby resulting in specific allocation of the funds drawn/invested for that investment plus any resulting income, gain or loss from the investment; as a result of defaulting investor there could be different allocations for any pre-and post-default-date investments; and there could also be other specific scenarios whereby the GP will decide to use specific allocations for specific items, for example, if the fund enters into credit facility certain partners may not participate in such credit facility and not bear any resulting interest charge.

Table 16.3: Allocations based on drawn commitment

	Commitments	Commitment %	Drawdown 1 (investment)*	Drawdown 1 (GP share)*	Investment 1*	Drawdown 2 **	Investment 2**	Income***	Expenses****
	£000s	%	£000s	£000s	£000s	£000s	£000s	£000s	£000s
Investor A	5,000	46%	455	50	455	556	556	56	23
Investor B	3,000	27%	273	30	273	333	333	33	14
Investor C	2,000	18%	182	20	182	-	-	-	9
FP/GP commitment	1,000	9%	90	-	90	111	111	11	4
Total	11,000	100%	1,000	100	1,000	1,000	1,000	100	50

* Fund draws down £1 million for investment and £100,000 for GP share

** Fund draws down another £1 million for a second investment & Investor C excused from the investment

*** £100,000 investment Income received at the end of the year from Investment 2

**** £50,000 total expenses incurred at the end of the year

Source: Author

Table 16.4 illustrates a simple example where specific drawdowns, investments and income/expenses have been allocated on a combination of investment-specific and commitment-allocation rule as a result of an excused investor. For example, Investor A has been allocated Drawdown 2 based on its proportion of commitment excluding Investor C's (excused Investor) commitment from the total commitment, that is, £5 million/£9 million.

An important thing to note is that any income resulting from investment 2 or any follow-on investment in investment 2 will also be allocated on

original investment allocation proportion, that is, excluding the excused Investor C. Also as a result of the excused Investor, the drawn/remaining commitment proportion and commitment proportion of all partners becomes different after Drawdown 2.

Other important considerations

Defaulting partner

A defaulting partner can make the allocations for a fund more complex and can have different impact on the allocations depending on the discretion of the GP. The main potential scenarios are:

- Continued allocations – if the GP anticipates selling the partnership interest to an existing or new partner, it will be practical to continue allocating the profits and losses to the defaulting partner as normal and then transfer the life-to-date profit and loss to the transferee partner(s). Until the defaulting partner share is transferred, the remaining investors will continue to fund the drawdowns based on the set-out allocation rule excluding the defaulting partner and the transferee partner on purchasing the secondary share of the defaulting partner will make up all the drawdowns to get the transferee partner in line with other partners.
- Amended allocations – if the GP anticipates not to sell the defaulting partner's partnership interest, in such cases the undrawn commitment of the defaulting partner will be written off thereby reducing the total commitment of the fund and any allocations up to the point of the default date will be frozen, and generally the defaulting partner will only be entitled on liquidation/termination maximum amount equal to the actual contributions subject to all other partners being paid their contributions first. This will imply that the defaulting partner will not be allocated any net profits and could potentially incur a maximum loss up to all its paid contributions depending on the final outcome at the end of the life of the fund. If the fund was in overall net profits at the distribution date and the defaulting partner has been allocated a share of these net profits, it will be prudent to reallocate these to the remaining partners based on the set-out allocation rule (excluding defaulting partner) and same should be done in case the defaulting partner has been allocated losses in excess of its paid-up contributions. After the default date, all net assets, profits and losses will be allocated between the remaining partners on the set out allocation rule excluding the defaulting partner, that is, either by excluding its commitment or contributions as the case may be depending on the

allocation rule.

The possible options listed above do not provide an exhaustive list of solutions in dealing with allocations in case of a defaulting partner and it will be at the GP's discretion to adopt a suitable, practical solution depending on the situation, the fund's performance and the terms of the LPA. In deciding a suitable solution the key consideration is to ensure that the remaining partners are not disadvantaged in any way.

Partner transfer

As discussed in [Chapter 8](#), the only way out for a partner during the term of a private equity fund is by selling its partnership interest to another existing or new investor following approval from the GP. The partner transfer is undertaken separately between the transferor and the transferee through a transfer agreement, which is outside the fund and does not directly impact the fund's operations or allocations. The only impact from the fund's point of view will be to transfer the balances from the transferor to the transferee on the basis of transfer percentage at the specified transfer date and going forward to continue to allocate all relevant transactions on a usual basis (that is, on the set-out allocation rule followed by the fund) to the transferee partner and the transferor partner if only part sale/transfer.

Allocations at the CIP/FP level

While this publication focuses on the accounting at the fund level, it is interesting to discuss very briefly few important aspects of allocations at the FP level. Once the allocations and distributions are finalised for the CIP at the fund level, these are passed through to the CIP entity (generally a limited partnership itself) to pass through to individual carried interest holders/beneficiaries.

The purpose is to incentivise the key staff, mainly the investment team on a good performance of their specific investments or as a fund as a whole and for the owners (the managing partners) to be able to draw their share of the performance profits. There are various possible allocations criteria to apportion the profit allocation and distributions among the carried interest holders, which comprise the following:

- By relevant proportion – whereby the manager will allocate a relevant percentage to various carried interest holders and amends these from time to time due to changes and/or additions in carried interest holders or due to other factors, for example, performance-

related/time-related increase in carried interest proportion. This criterion is probably seen more commonly than other criteria.

- By capital contribution – the manager will seek to set out capital contributions/commitment of the carried interest holders in the proportion of the required sharing percentage and profits allocated and cash distributed simply by capital contributions.

- By carried interest proportion/percentage – as in the case of relevant proportion just be allotting a carried interest percentage to each carried interest holder.

The above criteria relate to apportioning the cash-carry distribution and corresponding allocations passed through from the main fund, and the FP's own income and expenses are generally allocated between the partners on basis of capital contribution/commitment. While there are different allocation criteria for apportioning profits and distributions among at the carried interest holders, the underlying principle is the same in each case, that is, to allot a sharing percentage to each carried interest holder based mainly on ownership and performance and these are then amended from time to time.

As these are also generally closed-end partnerships, the total capital is initially contributed by the managing partners and any key staff at that time and subsequently with any change/addition of the carried interest holder, the managing partners relinquish a proportion of their share to accommodate a new member or increase in sharing proportion of existing member. The allocations at the FP level can be more complex than the allocations at the fund level as you not only have to consider tax efficiencies but also have to calculate or decide the proportion for the partners and key staff, which can be challenging. Further complications can result at when a member is changed or added in terms of transferring a proportion from the managing partner to the new and/or existing member, especially if there have been previous distributions from the fund and distributed to carried interest holders thereafter. Good-leaver versus bad-leaver criteria will also be an important deciding factor about how the allocations are adjusted.

Allocations at the GP level

These allocations are in reference to the management fees/GP share/PPS received by the GP. The allocations at the GP level for the GP share are relatively straightforward regardless of whether these are paid as an interest-free loan, profit allocation or management fee income. The GP will generally receive the GP share from the fund and only hold back any cash for its own expenses (and in some cases

partner drawings as well) and pass the remainder to the manager as management/advisory fee, which is then consumed mainly for payment of partner drawings, staff wages, bonuses and other manager expenses.

Conclusion

This chapter has shed some light on allocations for a private equity fund by discussing the importance and various characteristics of allocations. It has also addressed some key-allocation criteria along with simple illustrations. As usually is the case in private equity, tax efficiency is also a consideration when determining the allocation criteria. As mentioned in this chapter, as limited partnerships are generally tax-transparent and consequently the profits and losses of the partnership flow through to individual partners, the allocations are critical as the allocations dictate how partners will be taxed. While allocations are commonly based on partners' commitments and drive individual partners' tax computations, there are also instances where tax implications are a key deciding factor for specific allocation criteria selected by the GP. One of the key considerations for the GP in selecting the allocation criteria is the tax jurisdiction of its key investors and any associated tax implications for them, and as a result at times we can see multiple or specific allocation criteria for different transactions or classes of investors. Key financial regulations in investor jurisdictions can also be a key contributing factor resulting in specific allocation criteria being applied for different transactions or classes of investor, for example, specific allocation for Middle Eastern investors to comply with Shari'ah-compliant investment.

The key objective is that any allocation criteria selected by the GP should be fair and equitable, but also most tax-efficient for its investors and should be either in line or close to the distribution criteria set out in the agreement.

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Consolidation

By Angela Crawford-Ingle, Ambre Partners

This chapter discusses:

- The history and current developments which have an influence on reporting requirements
- The relevance of consolidation to private equity and the impact on funds, fund managers and investors
- The guidance provided under US, IAS, UK reporting frameworks and anticipated developments

Background

Over the centuries investors have always needed information but their needs have largely remained the same: ‘relevant information as quickly as possible’ remains the mantra of anyone who wants to understand what has happened to their investment.

Accounting guidance first appeared about 500 years ago in a 36-chapter book written by Pacioli¹ on mathematics, which addressed the accounting used “in order that the subjects of the most gracious Duke of Urbino may have complete instructions in the conduct of business”, and to “give the trader without delay information as to his assets and liabilities”. However, very little in the basic framework has changed over the centuries.

Different countries have embedded these standards in their own local frameworks in order to provide the information on a consistent basis and this trend has continued in to the present era with the formation of IASB and the convergence project with US GAAP.

While a continuing theme has been to increase the guidance from the original 36 short chapters to the volumes that exist today, there have

been two distinct routes about how the holy grail of consistently prepared information should be achieved. A continuing tension exists between those who believe you should set out the objective of the guidance and allow judgement to be exercised as to what that means in any particular situation, and those who believe that the interpretations of the guidance will be excessively divergent, if not abused, if rules are not clearly set out.

The standards are, in the main, designed to have a universal application to every conceivable business and so the natural evolution of bringing together all the information relevant to a trading business has resulted in the consolidation rules we know today.

The guidance of the major accounting bodies, with one notable exception (more of which later), does not explicitly contemplate the situation of an investing group as opposed to a trading group. Consequently the basic principle of providing information relevant to management and investors can be difficult to achieve. While some accounting frameworks do allow a degree of interpretation, or true and fair override, most are now rules based in order to prevent abuse. Given the wide range of investing structures used in private equity it is inevitable that some will need to comply with consolidation requirements regardless of whether the information is of any real benefit. It also leads to the situation where different presentations exist for the same investment proposition and consequently creating real difficulties when an investor is seeking to make performance comparisons.

It is important first to examine the reason for contemplating the topic of consolidation before diving into the detail of the rules.

The consolidation debate

The basic principle of consolidation rests on the fact that a single company controls one or more companies and therefore a group exists. There is a presumption that control exists through ownership and that the exercise of that control will result in receipt of economic benefits. Unfortunately in current times neither of those presumptions is necessarily valid as ably demonstrated by ENRON.

This chapter is aimed at the situation where a fund holds equity stakes in excess of 50 percent. Exemptions for accounting for stakes of less than 50 percent as associates already exist. There are two principle assessment points to consider when determining whether there is a

consolidation requirement:

- 1.Should the fund consolidate the underlying portfolio companies?
- 2.Should the manager consolidate the fund?

Consolidation of the fund

A fund is essentially regarded as a pooling vehicle to enable investments to be made efficiently. These investments could equally well be carried out in a club arrangement for which, due to the lack of any legal entity, the question of consolidation would not even arise.

Private equity funds are designed so that the manager, through its general partner (GP), controls the activities of the fund and the limited partners (LP) are passive investors. A further element in the analysis is that the GP group generally has the ability to control an investee company through representation on the board and the fund equity holding. In practice direct management control is rarely exercised other than in difficult situations requiring intervention.

One of the private equity industry's most successful processes to align the interests of both parties is the co-investment requirement. This leads to the manager owning at least 1 percent of the fund and often substantially more. The ability to control when combined with an equity stake leads to the need to analyse in more detail whether there is a consolidation requirement.

This question has absorbed a phenomenal amount of debating time over the years. Legal opinion has been sought in several cases about whether there is a consolidation requirement because the analysis of the underlying facts and accounting standards has been so complex. Each situation needs to be individually assessed, which is why there is no single solution available to the market.

The arguments to support non-consolidation are generally as follows:

- a.Investments are held for capital gain or other returns from financial investment.
- b.The fund's investments are likely to be in diverse and distinct operating businesses.
- c.The business activities of the portfolio companies are very different from each other and from that of the fund itself, which is to hold investments.
- d.There are no common arrangements which would be expected in a group such as management of employees, treasury

arrangements.

e. There is no interaction between the portfolio companies and the fund in matters which are generally managed on a consolidated basis such as taxation and recharges.

f. There is no business interaction between any of the parties.

While these arguments demonstrate the substance of the lack of any group relationship, the rules-based interpretation may still lead to consolidation. If the fund is consolidated into the manager there would be no consolidation requirement for the fund itself as it would no longer be regarded as the holding entity.

Consolidation into the fund manager

In private equity it is recognised that the fund is the ownership vehicle for the investors and that the manager runs the fund and the underlying portfolio companies for the benefit of those investors. Consequently the intuitive starting point is that the manager should not consolidate the fund. While the manager may run the fund it does so on behalf of the investors under the terms of its mandate and it does not have an ownership interest, and therefore it is not the holding company.

This is the so-called principle of fiduciary control, a concept which is not formally recognised in existing standards.

If the GP's interest in the fund is nominal and the benefits are on an arm's length basis this would be indicative of the GP acting in a fiduciary capacity. Furthermore, if the GP can be removed at short or no notice, it may be concluded that the GP is not able to exercise its power to control.

In order to demonstrate that a fund manager does not control the fund for consolidation purposes many funds have a 'kick-out' clause whereby a manager can be removed within a year without onerous conditions being imposed.

Where the GP (or a member of its group) has more than an insignificant investment in the fund and is entitled to a proportion of the returns, it would be difficult to argue that the GP does not exercise control over the limited partnerships and the investments and therefore should consolidate.

Investor reporting

However, if the argument that the manager does not control the fund has been won, thus allowing the manager to avoid consolidation, then natural logic would lead to the assumption that the fund should prepare consolidated results as it must then control the investments.

As can be imagined, this conclusion would not be the desired outcome for any investor as the resulting information would be absolutely meaningless for them. Aggregating cash balances and debt of investee companies which are not capable of being moved between them provides an extremely misleading picture of what is happening within the fund. Equally aggregated stock balances are not meaningful either. The common element in this analysis is the absence of any interaction between the individual portfolio companies means that the presentation of any aggregated information cannot be meaningful.

The only way to achieve the necessary management reporting for all parties is to argue that no-one controls the process. Although it would never be presented as simplistically as that, in essence that would be the underlying logic. Understandably when the case for non-consolidation in this situation is presented for clearance to the technical teams of the accountants, it is only their innate good manners which prevent one from hearing laughter over yet another effort to persuade that such a situation could actually exist.

The problem is that they are right in their assessment that someone must be controlling those majority-held investments. It is the reporting conventions that do not recognise an investment grouping as opposed to a trading group which is actually the root cause of the problem. When attempts have been made in the past to carve out an exemption for investment entities the problem has been how to define an investment group as opposed to a conglomerate with an aggressive acquisition and disposal programme driving shareholder value.

The point has been made frequently that there is little economic difference between a group such as GE and a private equity fund.

It is this desire to present meaningful information to investors that is an intrinsic part of the debate when structuring a new fund. The manager needs to consider the options available to avoid consolidation when selecting the reporting convention to be used. Typically, investors would be looking for information based either on their home-territory GAAP or an acceptable major GAAP alternative. If either of these routes leads to consolidation then it is quite common for the fund to define the accounting policies to be used. This can be done by

explicitly setting out the individual policies or, more commonly, by defining the GAAP framework to be used with carve-out exemptions for consolidation and any other framework policies that would not provide useful information.

The choice of GAAP typically rests between US, local country, IFRS or a fund-defined set of accounting policies agreed with investors when there is no local-jurisdiction reporting requirements. The remainder of this chapter considers the requirements of each in turn.

US GAAP

US GAAP stands out as the only major GAAP which explicitly caters for the requirements of the investing community. For those managers with the in-house expertise to handle US reporting it is an elegant solution to the consolidation debate.

The American Institute of Certified Public Accountants (AICPA) has issued guidance on accounting for investment companies. AICPA's guide originally defined an investment company as an entity that pools shareholders' funds to provide them with professional investment management. The drafting language used had public-reporting investment vehicles in mind' and in order to address the questions raised by private equity houses the definition was revised in order to clarify its application to private equity funds and other similar fund entities.

It now defines an investment company as any separate legal entity whose business purpose and activity is investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies.

It also addresses whether the principles of the guide can be retained by a parent company in consolidation or by an investor that has the ability to exercise significant influence over the investment company through equity-method accounting.

Under this guidance portfolio, companies in which the fund's ownership interests exceed 50 percent should not be consolidated and should be held at fair value with any changes in fair value being taken through the income statement.

Any investment holding structures are consolidated in the investment entity itself.

At this point it might reasonably be concluded that the debate is over. However, some jurisdictions do not permit the use of US GAAP as the principal reporting framework and so the manager would need to prepare two sets of financials, one for local consumption and one for investors with a reconciliation schedule between them. This extra workload generally prevents this route from being an option. There is also an understandable nervousness about applying accounting standards with which the reporting team have little or no familiarity.

IFRS

IFRS is a requirement for public reporting entities in many jurisdictions and increasingly has been used more widely due its acceptance in the international investment community. The analysis of whether a public-reporting private equity entity needs to consolidate its portfolio companies is complex and depends on the individual fact pattern.

By way of example, 3i Group does not consolidate its investments whereas Caledonia Investments does prepare consolidated results. In order to provide meaningful information to investors, Caledonia bases its results commentary on the holding company financial statements in which it holds its investments at valuation.

It provides full company disclosure alongside the consolidated financial statements which makes the presentation more complex.

Caledonia Investments

The directors present their analysis of results based on the company which is the equivalent of fund reporting.

Company	Group
	£m
Total revenue	205.6
Management fee	(10.2)
Investment profit	(10.0)
Trade operating	(126.2)
Other items	6.5
Profit before finance	75.7
Finance	(1.9)
Taxation	(6.2)
Profit for the year	67.6

The income statement demonstrates the disparity between company and group in the gross lines of revenue and expenses. While the net is closer it masks the fact that the company result contains the capital revaluation of £72m with no clear comparable within the Group result.

In May 2011 *IFRS 10, Consolidated Financial Statements*, and *IFRS 12, Disclosure of Interests in Other Entities*, were issued, both effective from January 1, 2013 with early application permitted. As these are new standards some examples have been provided to illustrate its application.

IFRS 10 provides a single consolidation model that identifies control as the basis for consolidation for all types of entities. It replaces *IAS 27, Consolidated and Separate Financial Statements*, and *SIC-12, Consolidation – Special Purpose Entities*, both of which have been used in private equity reporting.

IFRS 12 combines, enhances and replaces the disclosure requirements for subsidiaries, joint arrangements, associates and unconsolidated structured entities.

Perceived inconsistencies between the consolidation guidance in IAS 27 and SIC-12 resulted in diverse practices. These were particularly relevant to the private equity industry as differing treatments were adopted for:

- control without a majority of voting rights; and
- agency relationships such as funds or investment conduits.

Caledonia Investments

The balance sheet comparison highlights the level of debt which is not seen at the company level though some might argue this is relevant information to the investor. It is debatable whether the gross group balances are /meaningful to an investor.

Statement of financial position	Company
	2011 £m
Non-current assets	
Investments held at fair value	1,095.5

Other Investments	0.8
Intangible assets	7.6
Property, plant and equipment	81.1
Investment property	20.5
Interests in joint ventures	2.7
Deferred tax assets	4.7
Non-current assets	1,212.9

Current assets

Inventories	16.6
Trade and other receivables	29.1
Current tax assets	0.2
Cash and cash equivalents	121.5
Current assets	167.4

Total assets	1,380.3
---------------------	----------------

Current liabilities

Interest-bearing loans and borrowings	(48.2)
Trade and other payables	(31.8)
Employee benefits	(3.7)
Current tax liabilities	(2.6)
Provisions	(4.1)
Current liabilities	(90.4)

Non-current liabilities

Interest-bearing loans and borrowings	(30.8)
Employee benefits	(7.9)
Deferred tax liabilities	(2.0)
Non-current liabilities	(40.7)
Total liabilities	(131.1)

Net assets

IAS 27 used control as the basis for consolidation whilst SIC-12 focused more on risks and rewards. Although the guidance in SIC-12 applied to special purpose entities (SPE), there was confusion over which entities met the definition of an SPE and whether to apply IAS 27 or SIC-12.

IFRS 10 provides a definition of control that comprises the following three elements:

1. Power over an investee.
2. Exposure, or rights, to variable returns from an investee.
3. Ability to use power to affect the reporting entity's returns.

It does not set out a bright line as to how each of these elements combines or the weighting they should carry in the assessment. It leaves the final conclusion to the judgement of the preparer and their accountants. To assist in this judgement it provides examples and sets out requirements for situations when control is difficult to assess,

including cases involving potential voting rights, agency relationships, control of specified assets (silos) and circumstances in which voting rights are not the dominant factor in determining control.

Example: **Comparison of IFRS 10 to SIC-12**

An investment vehicle is created to purchase a portfolio of financial assets, funded by debt and equity instruments issued to a number of investors with the following attributes:

Equity tranche is designed to absorb the first losses and to receive residual returns of the investee.

Investor A holds 30 percent of the equity and is also the asset manager that manages the vehicle's asset portfolio within portfolio guidelines.

Asset management includes decisions about the selection, acquisition and disposal of the assets within portfolio guidelines and the management upon default of any asset in the portfolio.

According to IFRS 10, investor A controls the investment vehicle as investor A has the ability to direct the relevant activities, has rights to variable returns from the performance of the vehicle and has the ability to use its power to affect its own returns.

This is a different result when applying SIC-12 where some would conclude that investor A does not consolidate the investment vehicle as the 30 percent holding does not bear the majority of the risks and rewards. In addition, the investment vehicle was arguably created for the benefit of all investors, and not only for the benefit of investor A.

The new control definition reflects the fact that an investor can achieve power over an investee in many ways, not just through governing financial and operating policies.

The investor must assess whether it has rights to direct the relevant activities and although exposure to risks and rewards is an indicator of control, it is not the sole focus for consolidation for any type of entity.

When decision-making authority has been delegated by a principal to an agent, an agent in such a relationship does not control the entity. The principal that has delegated the decision-making authority would consolidate the entity. IFRS 10 provides a list of examples of parties that, by the nature of their relationship, might act as *de facto* agents for

the investor which includes Fund Managers.

Example: Fund managers

Fund manager M establishes, markets and manages a fund that provides investment opportunities to a number of investors. It makes decisions in the best interests of all investors and in accordance with the fund's governing agreements, but it has wide decision-making discretion. M receives a market-based fee equal to 1 percent of assets under management and 20 percent of all of the fund's profits above a hurdle rate.

Scenario 1

M has a 2 percent investment in the fund and the investors can remove the fund manager by a simple majority vote in the event of breach of contract.

M is likely to be an agent as 2 percent investment increases exposure to variability of returns but the exposure is not sufficient to indicate that M is acting as principal and its remuneration is at market.

Scenario 2

M has a more substantial pro rata investment in the fund and the investors can remove the fund manager by a simple majority vote in the event of breach of contract.

M is likely to be a principal as:

- removal rights are not considered substantive as they are exercisable only in case of breach of contract;
- a combination of M's remuneration together with its investment could create exposure to variability of returns from the activities of the fund that is of such significance that it indicates that M is the principal;

Scenario 3

M has a 20 percent investment in the fund. The fund has a board of directors, the members of which are independent from M and are appointed by other investors. The board of directors appoints M annually and the services performed by M could be performed by other fund managers in the industry.

M is likely to be an agent as the board of directors provides other investors with a mechanism to ensure that they can remove the fund

manager thus providing substantive removal rights. This outweighs the fact that M is exposed to significant exposure to variability of returns due to its combined remuneration and 20 percent interest in the fund.

While IFRS 10 has provided helpful guidance to fund managers it has not removed the potential for substantially different presentations of the same investment proposition that was evidenced in the comparison of 3i and Caledonia investments. Furthermore it increases the likelihood that the fund vehicle would have to consolidate the investments.

Following representations made by the British Venture Capital and Private Equity Association (BVCA), among others, in the IFRS 10 exposure draft process, the IASB agreed that investment entities could be considered for exemption from consolidation if an appropriate definition could be formulated.

In the words of IASB: “The objective of the project is to revise the definition of control and to enhance related disclosures. The topic of investment entities and whether they should be excluded from the consolidation requirements has been separated from the main project because of timing differences... The project is conducted jointly with the FASB though the two boards have different timelines ... Part two: Investment entities, Exposure draft to be published Q2 2011.”

IASB and FASB have a project to converge their respective reporting frameworks and consequently the anticipated exposure draft is expected to substantially mirror the AICPA guidance in that an investment entity should not consolidate investments in entities that it controls, but would measure those investments at fair value, with changes in fair value recognised in profit or loss. The exposure draft has not yet been released.

The definition of an investment entity is likely to have the following characteristics:

- a. Sole purpose of the entity is that of investment.
- b. Only invests for current income, capital appreciation, or both.
- c. Identified and documented potential exit strategies together with a defined timeframe.
- d. Ownership represented by units, such as ordinary shares or partnership interests, to which proportionate shares of net assets can be attributed.
- e. Investors, holding a significant interest and are unrelated to each

other, have pooled their funds for professional investment management.

f. All of the investments of the entity are managed, and their performance evaluated, on a fair value basis.

g. The entity is a reporting entity.

It is also envisioned that investment entities cannot be involved in the day-to-day management of the investee companies. Examples of involvement in the day-to-day management of the entity's investees:

a. Management on a continuous or repeated basis to investees or their affiliates. This excludes support services to investees that are limited to the period of time necessary to address a specific concern pertaining to a particular investee to maximise the value of the investment.

b. Directs the integration of operations of investees or their affiliates or the establishment of business relationships.

This definition allows for the typical interventions carried out by private equity as well as participation in board matters in a fiduciary capacity.

An investment entity is required to hold multiple investments at the same time directly or indirectly. However, there are likely to be exceptions for some of the situations encountered in private equity such as where the investment entity:

a. has not yet completed its initial offering period, or has not yet identified suitable investments;

b. is in its liquidation stage; and

c. for regulatory or other legal reasons, the structure has been set up in conjunction with another investment entity that holds multiple investments.

There will need to be an explicit commitment to a group of investors that the sole purpose of the entity is investment. This can be evidenced by the information memorandum and other corporate or partnership documents that set out investment objectives.

An entity that presents itself as a private equity investor with the objective of investing for capital appreciation has an express business purpose that is consistent with the business purpose of an investment entity. Alternatively, an entity that presents itself as an investor whose objective is jointly developing, producing or marketing products with its investees has an express business purpose that is inconsistent with investment.

As can be seen from the above, IASB is trying to formulate the guidance in such a way that genuine investment vehicles can take advantage of the exemption while preventing others from using the definitions to construct artificial entities which take development and research off balance sheet.

It is by no means certain that the exemption will be adopted because of the difficulty in creating definitions which prevent the exemption from being abused. However, if it is adopted it is likely the various country GAAPs will also permit the exemption.

Country GAAP and fund-defined requirements

All limited liability companies are required to prepare accounts in accordance with the requirements of the Companies Act in the UK. The UK accounting standards are generally an amplification of those requirements or set the standard where the act is silent.

UK standards focus on control combined with an equity stake. There is a rebuttable presumption that an equity stake in excess of 50 percent will give control but it is also considered that control can be exercised with a lower percentage. Some of the exemptions for consolidation in law, such as dissimilar activities, have in effect been removed by the interpretations set out in the accounting standards. Another example of an exemption which is not applicable for private equity purposes is “assets held for resale” as the standards have defined this as meaning disposal “within a year”. A clause in the Companies Act permits non-consolidation in special circumstances which are not defined. This exemption has typically only been used with legal opinion that it is appropriate in that particular circumstance.

A more common approach has been to use a true and fair override when the equity participation is insignificant. Differing interpretations have been applied about the level of equity holding which is eligible, ranging from less than 5 percent to less than 20 percent. This approach is not effective under IAS as the “presents fairly” equivalent is defined as being in accordance with IAS.

The majority of funds in the UK do not file accounts as they are not captured under the current legal interpretations. These funds typically use accepted GAAP with a consolidation and disclosure carve-out or a fund-defined basis, which is typically fair value-based.

The statutory instrument, which required non-limited liability structures that were in essence limited liability entities to file accounts under UK

standards, does not apply in the majority of cases. Where it does apply the fund need not prepare consolidated financial statements if it is consolidated into another company either fully, on an equity basis or proportionally. The latter is not an accepted basis in UK accounting and so is not considered.

The UK government is currently considering a revision to the statutory instrument, which has the potential to bring more funds into UK GAAP reporting. This highlights the importance of the proposed exemption for investment entities under IAS as once this comes into existence there is a high probability it will also be incorporated into UK GAAP.

Other country GAAP and fund-defined requirements

Each country will have its own reporting framework, which may be set out in law or through tax-based or investment directives. This section does not seek to set out the large range of possible presentations which is ultimately driven by the tax jurisdiction chosen for the domicile of the fund. If the fund domicile does not use a major accepted reporting GAAP then most investors would expect to receive further information which they can use for their own reporting purposes, which would be prepared on a fair value basis.

Concluding observations

At present there is a high degree of convergence between the major accounting frameworks. Most country-based frameworks are converging with IFRS, which has now recognised that the needs of an investment group are very different from other groupings of companies. In the past there has been a real reluctance by IASB to allow carve-out from its requirements for any industry on the basis that if it was allowed for one then there would be a proliferation of further exemptions. This is where the convergence with US GAAP has been helpful in the debate as there has been a long-standing exemption for investment entities. The *Investment Company Exposure Draft* is due out shortly and if adopted will provide the solution to end the interminable debates on consolidation for the majority.

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Previously, Angela was a senior partner at PwC with executive responsibility for running the Investment Management and Insurance Division. She was a board member of the European Investment Management Practice and a market leader for alternative investments with extensive experience of the private equity industry.

Angela is experienced in developing business platforms and teams across Europe and in the Middle East. She has advised company boards on their strategic issues and provides a blend of technical and commercial expertise: these companies have ranged in scale from global public-reporting entities to start-up ventures. Projects have included strategy reviews, rationalisation and selection of operating systems, design of appropriate reporting framework and reports, resolution of data issues and implementation of control systems.

¹ De Divina Proportione (About the divine proportions) by Fra Luca Bartolomeo de Pacioli.

Performance measurement:

is it all about IRRs?

By Alistair Hamilton, Inflexion Private Equity Partners LLP

This chapter discusses:

- How the performance of individual private equity funds are measured
- How the performance of a fund manager is measured
- How the performance of individual investee companies of a private equity fund is measured

Although all private equity professionals would agree that the internal rate of return (IRR) is a very important performance-measurement tool, it would be wrong to consider IRRs as all-encompassing when measuring performance. This chapter is structured into three distinct sections: firstly, it describes how the performance of an individual private equity fund is typically measured; secondly, how a fund manager is appraised; and finally it explains the basics of investee-company performance measurement. I will argue that there is no single, all-powerful tool for measuring performance in private equity. A range of approaches and metrics is required, as is a strong understanding of the basis of preparation.

As a private equity professional with a mid-market fund manager, I have drawn a number of examples from this industry subsector. While all firms will measure performance in their own way, there are strong parallels between firms in different parts of the industry. No doubt performance-measurement tools will continue to develop as the industry matures, but the fundamental performance metrics, being the

level of absolute return on capital invested, and the speed that this return is realised, will remain of central importance.

Performance measurement of individual funds

The performance measurement of individual private equity funds is a very important building block in the overall performance appraisal of fund managers, which makes starting the analysis at the fund level a logical introduction to the wider debate.

The principal metrics used in performance assessment could be viewed as a mysterious-sounding set of acronyms – IRR, PIC, DPI, RVPI and TVPI – without suitable definitions and explanation. None of these metrics are individually complicated, but the basis on which they are calculated needs to be properly understood to benchmark fairly.

Internal rate of return (IRR)

The IRR is the discount rate that makes the net present value of cash flow from a particular source equal to zero. Presenting a simple example using a single investment rather than a whole fund, if the investment was acquired for £100 and sold two years later for £121 then those cash flows have an IRR of 10 percent, being £100 multiplied by 110 percent, and then multiplied by 110 percent again. If the investment was sold for the same £121 after only six months the IRR would be 47 percent, and if it were sold after, say, ten years then the IRR would be 2 percent.

As you can no doubt imagine, this is a very important tool to use in benchmarking one fund against another, as all the fund cash inflows and outflows can be analysed and summarised in one individual and easy-to-understand statistic. What makes it even more appealing is that the calculation can be done in basic spreadsheet applications using one of the pre-programed functions (the XIRR function is best to use in Microsoft Excel).

It is not necessarily the case that the fund with the highest IRR is the best; it depends on many factors and also the basis of preparation.

IRRs can be presented in a range of different ways and funds can be operated in different manners, which can lead to materially different IRR results. *The European Private Equity and Venture Capital Association (EVCA) Reporting Guidelines* recommend a standard method for calculation, but there are many variations on this best

practice, examples of which are cited below.

Fund borrowing facilities, also known as capitalcall facilities

Some, but by no means all funds operate a capital-call facility. These are facilities set up with a bank that lends money to the fund so that investments can be purchased without drawing down cash from investors. Typically a bank will lend money to a fund for up to a year and at this point the loan from the bank is repaid via a capital call to investors.

As you can imagine, the fact that the investors might be putting their money into the fund a year later than the investment is made leads to a higher IRR result despite the money multiple, being the total returned cash divided by total cost, remaining the same. The IRR of the investment of £100 that I mentioned previously from an investor's perspective is 10 percent if it invested its money for two years, but it is 21 percent if the use of the borrowing facility results in the investor only investing its money for the second of the two years.

There is of course a cost to setting up and operating a capital-call facility, that is, the bank arrangement fees and interest, and so in reality the actual IRR would be marginally lower than the 21 percent quoted above.

An important point is that when appraising the performance of a fund it is important to make sure the appraiser understands whether a fund has been operated with or without a capital-call facility. Clearly the manager of the fund with a capital-call facility that returned an IRR of 21 percent is not more than twice as good as the manager that did not deploy a capital-call facility and that returned a 10 percent IRR.

Basis of preparation of the IRR calculations

IRRs can be presented in a number of different ways that give different results. The main difference in presentation is whether the cash flows are presented before or after a deduction for operating expenses and carried interest. A return quoted on the cash flows between the fund and the investee company before these deductions, which is defined by EVCA's Reporting Guidelines as the 'gross return on all investments', just considers the pretax investment-specific cash flows, and can give a materially higher result than on a postdeductions basis. The main expenses that net down the result are the priority profit share (PPS) (explained in [Chapter 12](#)) and carried interest, which is typically 20 percent of profits.

By way of an example, assuming a 2 percent per annum PPS (paid

every six months in advance) and a 20 percent carried interest on profits, the gross IRR (that is, predeductions) of the investment bought for £100 and sold for £121 after two years is simply the 10 percent described earlier. However, as shown below, the post-deductions return is 6 percent. An illustration of the timing and quantum of cash flows is shown in [Table 18.1](#).

Table 18.1: Gross vs. net IRR illustration	
	Gross
Jan 1, 2010	-100
Jan 1, 2010	-1
June 30, 2010	-1
Jan 1, 2011	-1
June 30, 2011	-1
Dec 31, 2011	-4.2
Dec 31, 2011	121
IRR	10%

Also, it is important to understand whether the IRR being quoted is that of the cash flows between the fund and the investors, or the cash flows between the fund and the investee companies. You might think that there would be very little difference between the two alternatives, however sometimes there can be a material difference between them.

As an example, a capital call could be made on January 1 for the £100 investment but, if there were unforeseen delays in the due diligence process then the investment might not be made for another three months. The IRR of the cash flows between the investors and the fund, (ignoring PPS, carry and similar items), would be 10 percent if the investment was sold and the proceeds distributed to investors after a total of two years after the drawdown. However, due to the three-month delay between the drawdown from investors and the actual investment date there is a shorter time period between the actual acquisition of the investee and the realisation. Therefore, the IRR between the fund and the investee would be higher (11.5 percent) than the IRR between investor and the fund. This principle is illustrated in [Table 18.2](#).

Table 18.2: IRR between the investors and the fund versus fund and the investee	
	Fund and investor
Jan 1, 2010	-100
Mar 31, 2010	100
Dec 31, 2011	121
IRR	10.6%

The important conclusion to draw is that the IRR is a powerful performance-measurement tool, but, as you will see later in this chapter, the IRR is a very commonly used benchmarking tool and so the results of IRR analysis always need to be considered in the context of how they have been calculated.

Other performance measurement tools

There are multiple other performance-measurement tools commonly used in private equity, some of which are described below. Using a range of performance-measurement tools is important so that overall performance of a fund can be assessed. In all cases though, as with calculating the IRR, an appraiser needs to make sure he or she understand the basis of preparation to benchmark appropriately.

TVPI (total value to paid in)

$$\text{TVPI} = (\text{realised value} + \text{unrealised value}) / \text{paid-in capital}$$

The realised value is the cumulative amount of distributions to date, the unrealised value (also called residual value) is the net asset value (NAV) of the fund and the paid-in capital is the cumulative contributions to date.

The result of the TVPI is what is sometimes referred to as the money multiple. This is because the result shows how much will be returned to investors for each unit of currency (£/\$/€) they invest.

Clearly this is a useful performance-monitoring statistic, particularly when it is combined with the IRR. The use of the two metrics together is powerful: the TVPI illustrates the overall cash-on-cash return of a fund and the IRR gives a guide as to how swiftly this cash-on-cash return is being made.

The key point to watch out for when using this performance metric, in addition to all the points raised with the IRR, is that the unrealised value is an inherently judgemental amount. As the principles of fair value are covered in detail in [Chapter 10](#) the issues are not repeated here, suffice to say that the TVPI statistic becomes less and less subjective as the fund reaches maturity and the proportion of realised value becomes larger.

DPI (distributions to paid-in capital) and RVPI (residual value to paid-in capital)

These performance metrics are subsets of the TVPI and so are useful in aiding an appraiser in understanding performance to date.

DPI = total distributions to investors /total capital paid into the fund

The DPI shows how much money the fund has returned compared to the amount paid in and as such is a reasonably non-subjective metric. This statistic gives an indication of the tangible progress that a fund has made in meeting its return objectives.

RVPI = valuation of unrealised investments /total capital paid in

The RVPI shows the value of the unrealised investments (also known as the residual value of a fund) compared to the amount paid in by investors. As such it is a measure of the amount of future value that the investor would hope to receive should the investments be sold at the valuation date. In reality the investment will not have been sold at the balance sheet date and so the proceeds that eventually are remitted to the investors may well be an entirely different figure.

PIC multiple (paidin capital multiple)

PIC multiple = paid-in capital to date /committed capital

The PIC multiple is a simple metric used to assess the stage at which a fund is in its lifecycle. If an investor made a commitment of £100 and had paid in £75 then the PIC multiple would be 0.75. A fund with a low PIC value is likely to be at an early stage of its investment period and a fund with a higher value of approximately 0.8 and above is likely to be around the end of its investment period. One consideration to look out for with this metric is that a fund with a PIC multiple of 1 has not necessarily drawn all its available capital. This clearly seems counter-intuitive, but the reason is that some funds are established with rules that allow certain commitments to be redrawn. Examples include circumstances when investors have paid in an amount that was subsequently returned if, for instance, a investment was not made due to issues emerging very late in a due diligence process (for more information on redrawable distributions, see [Chapter 13](#)).

Therefore, when using the PIC it is important to understand the current and future expected level of capital that can be redrawn to ensure that a full understanding is gained of the stage of the fund's maturity.

Reporting the performance of private equity funds

Private equity funds report on their performance in many ways. The most comprehensive way that performance is reported is typically via the quarterly reports that are issued by the fund managers to investors. A detailed analysis of the industry best practice reporting standards is covered in **Chapter 19**. The key point is that these reports should ideally contain all the financial information to allow investors to assess performance, both through quantitative information on both historic cash flows and current investee valuations, and also qualitative information describing the progress that individual investees are making in achieving their investment thesis.

Private equity funds will also usually require an annual financial audit to be carried out by independent auditors. The financial statements can therefore also be used as a means of monitoring performance. The benefit of using audited financial statements is that the investors have comfort that an independent firm has examined the books and agreed that the important numbers such as the investment valuations are true and fair.

The drawback is that the annual statutory accounts will typically be issued after the fourth quarter report has been sent to investors and so, as long as there are no material audit adjustments, they will simply report the same result to investors that went in the quarterly reports. Further to this, in most countries the statutory accounts also contain lengthy disclosures in certain areas that, while mandatory in order to meet with financial reporting standards, are not as well tailored to the specific needs of investors as the industry guidelines are.

There is also a number of well-respected industry benchmarking surveys through which performance is reported. Cambridge Associates issues a very comprehensive quarterly survey of fund IRR benchmarking, in which the firm presents the IRRs of a large sample of funds dating back many years and covering a range of geographies and industry subsectors.

The British Private Equity and Venture Capital Association (BVCA), in conjunction with other organisations (PricewaterhouseCoopers and Capital Dynamics), also carries out an annual performance survey, results of which are published in the summer. The BVCA survey is particularly comprehensive in that the sample of funds that it draws data from is very broad, and the lengthy historical context allows an interesting perspective on the performance of the asset class to be benchmarked to other areas.

Summary of performance measurement of individual funds

The key points made in this section.

- There is a range of commonly used fund-performance metrics, including IRR, TVPI, DPI, RVPI and PIC.
- No single metric can be used to fully appraise performance – they are best used in combination.
- You need to be fully aware of the basis of preparation of the metrics to properly benchmark performance.
- There is a number of ways that funds report on their performance, the most useful of these is typically the quarterly reports that follow industry benchmark standards.

Performance measurement of fund managers

The performance of individual fund managers is most comprehensively measured when a new fund needs to be raised. At this point potential investors will assess whether to make a long-term and usually sizable commitment to invest in a particular manager's fund. As an investment in a private equity fund is far less liquid than an investment in a publicly traded security, the decision to make a commitment is certainly not taken lightly. In making their decisions, the question that investors are seeking to answer is whether the manager will help them to meet their own objectives.

Investors will use both the past investment performance of the manager and an assessment of how the current investment team will continue to act in the future to make its decision.

Assessment of past performance

We all know the mantra that past performance does not provide any guarantees about future performance. This is certainly true, but nonetheless the past performance of a fund manager still needs to be thoroughly and forensically analysed. This is because this understanding of past performance allows benchmarking to other fund managers to be carried out more effectively.

In order to assess past performance investors will ask for a great deal of information, including the reports detailed in the following list.

- Performance metrics (for example, IRR, TVPI, DPI, RVPI and PIC)

for all funds that the manager has established, along with supporting cash-flow information and valuation calculations for unrealised investees. This is likely to be benchmarked to assess whether the manager's investment returns are beating their direct competitors, as well as the market.

- Deal-specific performance metrics for all investee companies both realised and unrealised (for example, gross and net IRRs and TVPI). This information is likely to be required for all investments that the key members of the investment team have made, regardless of whether they were working for their current or previous employer.

- Statistics to show the capital structures that the manager has invested into, showing the ranking of the financial instruments in the capital structure and therefore an indication of the level of risk associated with the investment.

- Case studies of the important investee companies that explain the investment lifecycle, including the origination process (that is, how the deal was sourced), the diligence process (how the investment decision was made), the investee-company performance data over the investment-hold period, and a description of any realisation process.

- Statistics to show the rate that a manager has invested the capital it has managed in previous years.

- Financial analysis to show how the manager has created value for investors on both a-whole-of-fund and individual investee-company level. This is typically presented in some form of value progression graph, with the overall return broken down into value coming from earnings growth, multiple expansion and deleverage. More detailed analysis of the difference sources of earnings growth may well also be required (that is, whether the earnings growth comes from cost-cutting, sales growth from the core market, new products and new international markets).

In order for an investor to assess whether past performance is a reasonable indicator of future returns it will require other information to help it reach its conclusion. This is likely to include the sort of information detailed in the following list.

- An opportunity to meet the investment team or as a minimum to meet the key members of the team, so that they can assess the quality and motivations of those that they will entrust to invest their money.

- An analysis of the salaries, bonuses and carried interest allocated to each investment team member. This is used to assess the likelihood of the team staying stable in the years to come.

- Explanations of any investment team changes, particularly any 'bad leavers'. Investors may well ask to contact leavers directly for a reference on the fund manager.
- Recent references from important stakeholders (for example, bankers, investee-company chairman and executives, lawyers and other professional advisers).
- Country/market sector economic reports might be sought by the investors, which may well be based on the other side of the world, as to whether a particular fund's niche is expected to be a fruitful area for investment in the medium-to-long term.
- A description of the manager's approach in sourcing new potential investments, with supporting evidence, along with the manager's current work in progress.

Once all this information has been compiled and assessed the potential investor will be in a good position to assess the overall performance of the manager.

Summary of performance measurement of a fund manager

The key points made in this section:

- The fund-performance metrics discussed in the first part of this chapter are an important part of the measurement of the performance of a fund manager.
- There is a much wider range of information that needs to be sourced and appraised to understand a full overall view on performance.
- This information needs to cover the past performance so that the returns statistics can be understood.
- It also needs to cover an assessment of the way that the manager is currently operating, along with an assessment of the likelihood of this continuing.

Performance measurement of investee companies in private equity funds

Until a manager has substantially realised a fund's portfolio of investments it is very important that there is insightful measurement of the performance of investee companies in order to facilitate a high standard of appraisal of fund performance. This is because a full understanding of the investee-company performance is vital in the

assessment of the fair value of the investment, and the fair value of the investments will have a very material effect on the important fund performance metrics such as IRR and TVPI.

By way of an example, if an investee company's performance trends and its market are misunderstood there could quite easily be a material margin of error in the assessment of the company's maintainable earnings, and also the valuation multiple. Table 18.3 shows the huge effect this sort of error can have on the valuation of an investee company using a margin of error of 20 percent.

As shown in Table 18.3, the resultant knock-on effect of this valuation discrepancy on fund-performance metrics is certainly very significant. If, for example, 100 percent of the share capital of the investee company in the cited scenario was purchased five years ago for £15 million then the IRR in scenario A is a respectable 12 percent, but in scenario B, after a 20 percent reduction in earnings and the multiple, the IRR has fallen to a rather less respectable -3 percent. The equivalent difference in the TVPI between the two scenarios would be 1.7x and 0.9x, respectively.

As you can imagine, if these sort of errors are compounded across a portfolio of investments the results could be very misleading.

Table 18.3: Alternative valuation scenarios	
	Difference (£ or %)
Maintainable earnings	20%
Valuation multiple	20%
Enterprise value	28,040
Surplus cash	5,000
Senior bank debt	(15,000)
Loan from private equity	(15,000)
Equity value	(12,960)
Resultant IRRs from the alternative valuations	
Jan 1, 2010	(15,000)
Jan 1, 2015 (equity)	28,040
IRR	(3%)
TVPI	0.9

For a fund manager to monitor the performance of investee companies it needs to get as close as possible to the company's financial results and the executive team running the business. The information a fund manager will receive from the executive management team does not need to be vast, but it does need to be well focused. Portfolio management is both a science and an art; it requires highly honed numerical analysis and also strong interpersonal skills.

Arguably this area is complex enough to justify a book in its own right, but the key areas of performance monitoring of a private equity fund's investee company are contained in the following list.

- Non-executive directors are appointed to the board by the fund manager. These directors will typically be experienced investment directors or portfolio managers who are essentially the 'eyes and ears' of the fund. Their collective job is to challenge the executive management team to help drive the company to meet, or indeed exceed its business plan, and to support them with advice, guidance and capital where appropriate.
- Refinement of key performance indicators (KPIs) and effective monitoring tools. The monthly management accounts are typically the most important monitoring tool. A well-constructed set of management accounts will present historic performance, explain the important variables (for example, trading trends and KPIs), give an indication of future performance and flag up risks and opportunities.
- Budgets and medium-term strategic plans are important in setting the aspiration for the future performance of the business. The budget will be typically pulled together by the finance director, but it needs to have input from all areas of the business before being signed off by the shareholders. The budget needs to be both challenging and achievable. Budgets typically only run for the following 12 months whereas medium-term strategic plans are usually set for a three-to-five year time horizon. Such plans are developed by the executive management team in conjunction with the nonexecutive directors. They lay out the path for shareholder value-creation and so are important for investors and employees alike.
- Market data and comparable company analysis. This is vital in both assessing the reasonableness of the budgets and strategic plans, as well as the multiples used in investment valuations.
- Typical performance metrics. Some metrics are more relevant to a specific investee company than others – this will depend on the nature of the company's trade and the stage in its growth cycle. The core metrics that are typically used include the following:
 - ◆ Compound annual growth rates (CAGRs), being the rate of compound growth, which are usually presented for sales and profit. For example, if profit has grown from £10 to £15 in two years then there has been an absolute increase of 50 percent, or a CAGR of 22.5 percent. The higher the CAGR, the faster the company's growth.
 - ◆ Gross profit margin is the gross profit divided by the sales.
 - ◆ EBITDA profit margin is a company's earnings before interest,

tax, depreciation and amortisation, divided by sales, hence the acronym. EBITDA is typically used as a proxy for the free cash flow that a company produces, which can be paid to the financial stakeholders such as shareholders or banks that have lent the company money. The higher the profit margin the better.

◆PE ratio is the net profit (or profit after all costs, including tax, interest, depreciation, and amortisation have been deducted) divided by sales.

◆Cash-conversion ratio is the amount of cash that a company brings in from its trading operations divided by operating profit. This is used as some companies will require more cash (than other companies) to be tied up in the business as it grows. Investors are typically keener on businesses with a higher cash-conversion ratio as more 'free cash flow' is produced that can be paid to investors as the company grows.

Summary of performance measurement of an investee company

The key points made in this section:

- Good-quality performance measurement of investee companies is vital for the creation of reliable fund performance metrics.
- Good-quality performance measurement of investee companies requires a strong understanding of a company's financial data and its constituent market.
- Strong understanding will come from analytical review of a company's reporting tools, such as management account and budgets, and strong interpersonal skills that are required of the non-executive directors appointed to represent the fund to ensure an effective information flow is maintained.
- There is a range of performance metrics that can be used to assess investee-company performance, for example, CAGR and EBITDA margin. Some are more relevant to an individual investee company than others.

Conclusion

Throughout this chapter I have explained the wide range of performance-monitoring tools in private equity – IRR is important, but it is by no means the only important measure of performance. There is a very important role for private equity accountants to play in performance measurement, both from the perspective of compiling

data properly and for the recipient to analyse it properly. This is true for each area of performance monitoring, being that of an individual fund, the fund manager and also of individual investee companies.

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Before joining Inflexion in 2006, Alistair trained as a chartered accountant, working in PricewaterhouseCoopers' growing businesses practice, where he managed a portfolio of public and private equity-owned audit clients. He also spent time working in PwC's transaction services, corporate recovery, tax and corporate social responsibility practices. Alistair holds a BSc in Geography from the University of Bristol.

Reporting requirements for investor relations purposes

By Monika Nachyla

This chapter discusses:

- The role of investor relations professionals.
- A summary of investor meetings and events
 - ◆ Reporting requirements for investor relations purposes
 - ◆ Industry best practice and EVCA and BVCA reporting guidelines
 - ◆ Possible new solutions for accounting processes.

Introduction

From the outset of this chapter it is important to bear in mind why private equity funds need investor relations, what investor relations is really about and if investor relations officers have a mission. Investment in a private equity fund by a limited partner (LP) raises one fundamental question: how is the fund performing? This question must be regularly answered throughout the entire fund lifecycle, which in general means over a timeframe of 12 years or slightly less. Questions focusing on fund performance will assess whether the fund investment was a good or bad choice, if it is likely to generate the expected returns and importantly whether it should it be followed by a subsequent fund investment. These are the dilemmas each LP faces constantly. Lessons learned from these investments are incorporated into an investor's in-house investment know-how and pave the way for future approaches by:

- avoiding future mistakes of investing in bad funds; and

- introducing internal procedures allowing building of risk-differentiated portfolios.

Each LP needs information to be able to answer such critical answers. Information must be provided by the general partner (GP) and should be relevant, complete, timely and easy to digest. It should be standard practice that the information should also be true and fair, and prepared according to industry best practice and accounting standards. However, all the above-mentioned attributes also make it complicated. It is important to mention that providing information to investors may be one consideration, but each GP needs to gather, organise and use data about its current and potential investors. This function is equally valuable and allows for:

- building a comprehensive database of current and potential investors; and
- managing continuing and archiving historical communication with investors.

Both databases and archives are very helpful tools in managing everyday relations with investors, adding to the overall dimension of an individual approach to each LP. In the current private equity market of late 2011, there are several ways to facilitate and optimise what is termed the investor database. Traditional in-house Microsoft Excel-based solutions (paper-based approaches are considered extinct species) can now be easily replaced by widely offered IT products. Applications often already include full sets of updated and readily usable investor data. The major inconvenience is that these are hardly available free of charge. The usual content is structured around contact details for the investors, their officers and the history of cooperation with the GP, such as individual commitments for each fund. The more sophisticated databases include investors' preferences and investment strategies, as well as various search and document-storage options. In addition, some software providers also offer integration of the database with internal email software. Using those tools makes life easier for the investor relations function, but also optimises time spent on the most critical tasks.

Everyday investor relations can be divided into three different categories: reporting, individual communication and meetings. Reporting is the most regulated and standardised field of investor relations operations and will be presented in detail in the following chapter.

Individual communication with investors has no standard formats or

templates; it comprises mutually agreed reports prepared for the each investor, one-on-one meetings, conversations or updates. The variety of reports is very broad, comprising specific tax forms, such as K-1s in the US, yearly environmental portfolio reviews and specific management fee or forecast cash-flow simulations. An investor relations team is in charge of answering all those requests and even more for proactive communication in case of extraordinary events. Investor relations should be internally empowered to deliver information about portfolio-crisis situations, organisational changes within the GP or any other sensitive data. Arguably, for the GP this is the most crucial part of all interactions with LPs. Direct discussions facilitate personal relationships with an investor, mutual trust and understanding priorities.

It is worth mentioning that such reports are always subject to negotiations between an investor and the GP, for most of them even before the commitment of funds. An interesting outcome of this negotiation is for the GP to have different reporting agreed for each investor, which is a common practice in the industry. The least predictable part of daily operations in investor relations is *ad hoc* requests. Most often, these relate to specific situations faced by an investor, such as their own fundraising, disposal of commitment, audits, tax controls or internal reviews. In such instances, the biggest challenge is usually down to a very short deadline to deliver data, which puts investor relations and accounting staff under unexpected pressure. The additional psychological difficulty for investor relations is to manage communication with the investor's team, which might be under considerable stress. In my experience, the short delivery time in these cases is the most critical feature, which can even result in compromising on the degree of detail.

Fundraising time has its specific reporting packages as well, usually included in the due diligence questionnaire or due diligence package. These are defined by internal procedures of each investor and requested from the GP at the initial stage of the due diligence process. Most GPs also prepare a private placement memorandum (PPM) outlining the fund's investment strategy and premises for a new fund as well as a vendor due diligence report, gathering summarised historical data in advance. Accounting teams are entrusted with completing most of these reports as well as some input to the PPM, which creates a great additional workload during fundraising.

Investor meetings are customarily regulated by the limited partnership agreement (LPA) or a GP's internal policy, which will define frequency, timing, attendees and responsibilities. The most common examples of

such events are briefly presented in [Figure 19.1](#).

Figure 19.1: A summary of investor meetings and events

Meetings

- Annual results
- Performance of each portfolio company

The fund development team interacts with LPs, provide full updates and answer queries about fundraising and strategy, the macroeconomic situation

Advisors

Annual or intermediate results

Portfolio performance presented by the deal teams, including

Discussion of key body points with formal responsibilities for LPA-defined tasks (conflicts of interest for sister funds, defaulting investors, overall performance (advisance with investment premise))

These meetings most often take place in a teleconference format. The ideal composition for this committee would be: a senior investor, an external expert and fund representatives

Approval of commitments or exits from existing portfolio

Discussion and voting of the specific points regulated by LPA (case would be reduction of the fund or replacement of the GP)

Called for by the relevant group of investors: a special execution tool for investors to react in case of unsatisfactory GP performance
All or majority of investors

The investor relations team is fully responsible to organise all these meetings: they must be planned and agreed well ahead with participating investors. The first two types of meetings, illustrated in [Figure 19.1](#), are important events in a GP's life, requiring a heavy contribution from the investment and accounting teams. These gatherings most often combine a summary of regular reporting circulated to investors in advance of the meeting, discussions with investment officers on the individual portfolio companies and electronic presentations. GPs often include some entertainment element in the agenda to add a personal touch to these meetings and to help build personal relationships.

Since private equity teams focus all of their time on investing funds, monitoring and exiting portfolio companies, the reporting and information functions require additional resources – these are the investor relations team's responsibilities.

There are several ways of approaching investor relations in terms of relevant resource allocation. A common approach, typical for small funds, is to charge one or several senior investment officers with investor relations responsibilities. Small-size investment teams or young organisations choose this solution to be as close as possible to their investors and to limit costs. Selected officers meet regularly with

the investors, present the current status, review reporting and share their time between two areas of activity. When organisations grow in size and in operational complexity, most of GPs decide to specialise and dedicate officers to selected areas of activity, most often including investor relations, a team which will grow typically from one person into a whole department. Considering the current private equity industry, outsourced IR functions managed by placement agents or specialised consultants are available.

However, investor relations is an area the GP should always keep in-house. This allows a GP to control information flow to investors, constantly measuring their enthusiasm about the group, gives unique insight about their needs, satisfaction levels and potential to raise the next fund. My field experience, which has proved to work well, has involved a combination of a fully dedicated, senior investor relations in-house resource with some involvement from senior investment officers. Allocation of the latter should strongly depend on the fund's lifecycle – the closer to the fundraising, the greater the involvement of investment partners.

The last important point to introduce is the investor relations mission. No matter how pompous this may sound, the investor relations role is sensitive and difficult. The sensitivity relates to the fact that investor relations officers, who are a part of the GP team (on the payroll, after all), should also be considered as the investors' people. Channelling and undersigning most of the information for LPs, building personal relationships and gaining trust creates a strong and reliable expectation on the investors' part. Therefore, the key challenge for each investor relations officer is to provide information, which is well balanced and trustworthy but also informative and transparent. If successful in delivering on this mission, investor relations officers gain a strong reputation among LPs and play one of the key roles in the organisation.

Reporting requirements for investor relations purposes

What do investors look for in terms of communicating with their GPs? What are the key areas of interest and how does current reporting practice address them? How does accounting support communication requirements?

After deciding to invest in a private equity fund, an investor would generally set a number of reporting requirements that need to be met

by the GP. Most of these requirements are performance-related and can be classified into three main categories, broadly following the categorisation in [Chapter 18](#) which focuses on performance metrics. These categories exclude *ad hoc* requests specific to individual investors such as environmental or tax reports. They are follows:

1.Financial position and fund performance: The fund's financial position is presented in the statutory financial statements, delivering a quantitative measurement of interim results achieved by the fund, summarising historical cash flows and net results achieved by the GP in the particular fund, while the fund performance is presented in the quarterly investor report.

2.Portfolio performance: Portfolio valuations are included in the balance sheet and further in the portfolio reporting as part of the quarterly investor report. Separate portfolio-performance sections designed by the GP present company performance and recent developments. Accounting and investment teams establish valuations jointly, while deal teams fill in performance sections. Portfolio reports should allow investors to understand progress in portfolio value creation, and hopefully any potential risk to this value.

3.GP team performance: There is no clear practice when directly presenting team member performance. Investors draw conclusions on team efficiency from overall results.

Financial statements

The first group of reports already agreed during the initial investment negotiation phase is financial statements. Like any commercial organisation, a private equity fund must present accurate records prepared in accordance with mutually agreed accounting framework for all its transactions. The most frequently recognised accounting frameworks adopted are US GAAP and IFRS; for funds established as English limited partnerships (or equivalent) it is UK GAAP; or if not a qualifying partnership – probably the most preferred flexible accounting framework – investor-defined or LPA GAAP is most appropriate, as explained in detail in [Chapter 15](#). These financial statements provide a true and fair picture of the financial position of the fund, with additional, individual capital information for each investor. They are processed by investors' accounting departments and consolidated into their financial statements. Fund financial statements are explained in detail in [Chapter 15](#). Additional financial information, which is not mandatory, may be required by investors to be provided in the notes to the fund financial statements; for example, a detailed breakdown of fund

expenses, as well as the management fee calculation. A detailed description of organisational expenses is usually required in the first year of a fund's life, since there is usually a separate agreement on the amount allowed for such expenses.

This set of standard data – prepared by the fund's accounting department or outsourced accounting service provider – is actually statistical in nature and presents a historical view of overall performance. Given that all funds follow standard accounting principles, except when a flexible accounting framework has been adopted as previously explained, the same report types across all funds offer easily comparable information.

In addition to the financial statements, individual capital accounts for each investor are also produced by the fund accountants, allowing immediate understanding of their contributions and received benefits. These are:

- the interest of each investor in the net income and gains/losses of the fund; and
- the amount credited and debited to the capital account of each investor as of the reporting date.

These summarise most quantitative aspects of the GP's performance and should hopefully be easily reconcilable with each investor's internal accounting records. These audited financial statements are expected from the GP once a year, usually within 90 days after the end of the fiscal year. To facilitate an investor's year-end closing procedures, observing such deadlines is considered critical in investor relations reporting.

It is critical to remember that financial data is the most fundamental information required by limited partners and the most strictly observed reporting obligation. Financial statements deliver investors a quasi-insurance policy of accuracy, especially once audited and signed off by the auditor.

When analysing fund financial statements, each investor can track actual amounts invested into portfolio companies, realised gains and expenses incurred. Interestingly, the latter receive the most attention. In my extensive practice in discussing financials with investors, the nature of portfolio-related costs and GP expenses prompt the most questions within the financial statements area. Despite standardised accounting classifications for expenses, this category is the most difficult to interpret from statements, often requiring individual

explanation on a line-by-line basis, and involves subjective evaluation of justifications.

The first category (portfolio-related costs) is usually associated with investors trying to understand their net results, which ultimately count the most when distinguishing between good and weak funds. With this in mind, net results at fund level, which are presented in simple form in the profit & loss account, are considered as important as the net results of individual investments. The latter must be extracted on a case-by-case basis and are not offered as standard information by GPs. This leads to frequent investor requests for a split of investment-related costs for each deal. Net results achieved on an individual investment help assess the original investment thesis presented by the GP and confirm selected investment strategy components, such as an industry or geography approach.

In conclusion, presenting detailed information on portfolio-related costs for each investment that goes beyond standard reporting creates more transparency for investors and eliminates doubts about real net return.

A GP's expenses policy covers personnel remuneration and fund-administration costs, among other items, but also external services and fees, including broken-deal expenses. Why is there so much interest in expenses policy? The eternal conflict between private equity funds and their investors hinges on maintaining a balance between what is understood to be a reasonable management fee and carried interest benefit. Investors demonstrate growing discomfort with the level of management fees, considering GPs to have more-than-generous fixed compensation and unreasonable aborted-deal costs for consultants and lawyers. At the same time, GPs fight for the highest quality of investment staff, who are expensive to hire and motivate. Increased aborted-deal costs result from the increasing complexity of contemporary business models, and the necessity to offer sophisticated deal and financing structures. All of this requires more time and specialised resources. Presenting such a degree of detail is possible and could be easily delivered by most accounting systems.

In order to manage investor data needs and provide more comfort about alignment of interest with limited partners, GPs should be encouraged to prepare additional explanations on expenses beyond standard profit and loss.

The due diligence phase is a special case in investor communications. Accounting and investor relations teams are extremely busy during this period, building up a historical track record for previous funds. Most

attention is devoted to detailed cash flows and net internal rates of return (IRR) at the fund and portfolio-investment levels. In particular, investor due diligence teams monitor the following:

- J-Curve for each investment.
- Valuation progress over the investment lifecycle.
- Investment thesis versus final outcome for each investment.
- Validity of investment strategy through successful deals ratio.
- Actual net returns for each deal and fund, as evidence for the investment decision.

Accounting records can provide the raw data to calculate and present of all of the above reports, but the critical consideration is to design and provide the relevant reports from inception and throughout the whole life of the fund. Would there be any harm in providing this information regularly in addition to the standard reports? No, of course not as this would make life easier for everyone: for the GP, it reduces the time taken to prepare due diligence packages; for investors, it helps them complete in advance their homework on future fundraisings. In addition, while acquiring new investors in between fundraisings, investor relations officers frequently receive requests for cash flows and IRRs as part of initial verification and as part of a 'let's get to know each other' approach. The usual practice is to refuse or postpone delivery until the next fundraising when records are updated. Providing a new party with a full set of information at any moment is troublesome and does not always generate positive results. This should depend on the GP's individual information policy. However, having such data available can help better facilitate and manage such a policy, ultimately offering early full disclosure to preferred investors.

Portfolio performance

The underlying portfolio is obviously the most important element in developing future fund value and returns. In Europe, the standard portfolio-related reporting package is usually based on *European Private Equity and Venture Capital Association (EVCA) Reporting Guidelines* or British Private Equity and Venture Capital Association (BVCA) reporting guidelines for UK funds, which are essentially the same as the EVCA Reporting Guidelines; the final shape is individually determined by the GP. The guidelines are discussed in more detail later in this chapter. It transpires from several discussions with investors that their main goal in reviewing this part of reporting is to understand well the company's business. This means not only a company's statistical data and business model, which are typically

included, but also future growth prospects, continuing performance versus initial expectations and potential risks. The most frequently missing pieces of information are:

- presentation of the investment historical lifecycle and value progression;
- forecast results and potential exit valuation;
- immediate warning on underperforming investments or extraordinary events affecting investment value; and
- business, operational, personnel and other risks.

There might be several answers why private equity managers avoid including the above details. The most obvious reason is to refrain from any commitment to future returns that might be thought to be speculative. Regulatory limitations on presenting forecasts also discourage many GPs. The other reason might be the major additional workload for investment staff if they are required to present qualitative investment evaluations. Dedicated officers would need to be engaged directly to carry out systematic reporting work together with the accounting teams in order to gather and present such data. Finally, describing existing risks, problems or crisis situations would certainly encourage investor attention and provoke uncomfortable questions. It seems to be quite a challenge to admit and objectively describe issues as they arise. The truth is that the GP can build or strengthen mutual trust with investors by offering sensitive data in advance. Overcoming the prejudice that the later information is provided the more diligence can be applied and the more satisfactory will be the message, demonstrates professionalism and responsibility.

Valuation conflict

What portfolio reporting usually offers is statistical data, actual financial results and the current manager's valuation. This is not enough for investors to form a full view on the prospective value of each investment and monitor risk.

Private equity funds tend to present current portfolio value based on EVCA valuation guidelines, but mostly following the so-called manager's valuation. Investors often open discussions on manager's valuations by requesting a less judgemental approach. What are the usual key requests? More aggressive and quicker discounts, more statistical back-up and market information.

GP team performance

An interesting and quite surprising phenomenon is that despite very detailed analysis of the individual track record of each investment team member at the due diligence stage, there is no further investigation into personal performance after fund formation. Unlike other business organisations, monitoring performance of all top executives, sales professionals or key managers, private equity houses hardly ever produce individual profit & loss statements. Accounting records of the private equity teams rarely disaggregate transactions and incurred expenses for each officer, and are hardly ever presented to investors in this way. Certainly, each team would find sufficient explanations for this situation and why changing it is impossible. But since a fund's returns comprise returns from individual deals, why not look at them as an aggregation of individual efforts? Why hide single investment decisions behind the general fund performance, and why hide individuals behind the team?

Investors are not offered regular information on officers' track records and individual profit & loss accounts as a part of standard reporting packages, even though accounting records offer this opportunity.

Industry best practice – EVCA reporting guidelines

How are the key areas of interest addressed by the EVCA proposition? Which elements are not covered?

Before discussing how EVCA reporting guidelines influence the life of a GP, here is a quick explanation about what EVCA is and how the guidelines came about. The general definition reads: "The European Private Equity and Venture Capital Association (EVCA) is a member-based, non-profit trade association and was established in 1983 and is based in Brussels. EVCA represents, promotes and protects the interests of the European private equity and venture capital industry." In practice, this is a well-established, very active institution focused on helping all members to run their businesses. This help includes representing its members in formal forums, provision of statistical data about the private equity market, offering specialised education and know-how, as well as attempting to standardise and somehow civilise the industry. There are also several projects and activities conducted by EVCA not relevant to this chapter. A 2005 initiative to create reporting guidelines was an EVCA project within its standardisation field of activity. As in all other projects, EVCA created a dedicated taskforce, which became responsible for writing the document and cooperating with the EVCA administration in running its approval

process. Eight members of the taskforce, including myself, met several times for brainstorming sessions and discussions.

It would be a gross overstatement to say that all went smoothly and without differences of opinion. Since the taskforce purposely had a representation of LPs, small, medium and large GPs, it was obvious the group might run into conflicts of interest, which actually became the case. Each representative provided unique insight into his or her niche, outlined key priorities and tried to defend their kind of interest. Sensitive topics such as the valuation approach, possible reporting deadlines or degree of provided detail had to be examined from different perspectives. In effect, we worked out a compromise, which could be viewed as far from ideal for everybody, but I believe it provides a relatively good solution for most players in private equity. As part of a typical EVCA approval procedure, the document was publicly consulted with all members, with several comments and suggestions incorporated adding another level of comfort on how useful these guidelines are. Consultations, drafting, and adjustments featured several stages, assuring the document had very good exposure to the industry. What is interesting is that the majority of taskforce members have a strong involvement in audit, accounting and finance functions, or had in the past, so we understood well the key challenges for key users of the guidelines: accountants. I do hope that overall we made their lives easier.

Financial statements and fund reporting

The main focus of the EVCA guidelines is on complementary fund reporting, portfolio reporting, capital accounts and expenses. Additionally, the document provides two types of guidance: requirements, which must be applied to enable a fund manager to claim compliance with the guidelines, and recommendations, adoption thereof is left to GP discretion.

Requirements for fund reporting include the following: current investments (significant events); new investments; realisations; significant changes to the management company or to the general partner; changes in portfolio or fund strategy; material risks to the performance of the fund as a whole; and events that have had, or might have, an impact on the future performance of the fund. The majority of these monitor statistical data and summarise general threats to the fund.

EVCA guidelines do not discuss financial statements, because these

are governed by limited partnership agreements and the law of the jurisdictions in which the fund is established. Therefore, the guidelines do not cover specific investor needs for detailed analysis of costs and expenses, related to both investments and the organisation.

Portfolio performance

EVCA recommendations for portfolio monitoring are divided into the following groups:

- 1.Realisation summary – a statement of all received realisations.
- 2.Current portfolio summary – brief legal description of the holding and historical and statistical records.
- 3.Specific information concerning each investment – this section is devoted to investment valuation and gross IRRs, valuation methodology and information about share prices, exchange rates and dividends received.
- 4.Significant events and issues.
- 5.Historic profit and loss and key performance indicators.
- 6.An assessment of the company's status compared to the expectation at the time of investment.

Summarising EVCA portfolio reporting recommendations, the key focus is again on quantitative data and statistical information. The largest part of these reports should be delivered by accounting. Despite the comprehensive and detailed nature of the recommended reports, there is insufficient basis for understanding real portfolio quality.

GP team performance: individual performance of team members is not covered by EVCA guidelines.

Accounting – possible new solutions

Financial statements

How can reporting be improved to cover investor requests? Is accounting in a position to deliver all the necessary data? Does timing matter in providing information?

Every fund manager invests a lot of time and effort to create an optimum set of accounts as well as financial reporting. The final shape of the documentation produced depends on accounting standards, market practice, including EVCA or BVCA guidelines and finally on

team experience. To add to this experience, some proposals below show how to meet additional investor requests.

Fund expenses and GP expenses policy

As described before, detailed information on expenses could help in eliminating many additional questions from investors. An example of such a report as in example report one.

Figure 19.2: **Example report one**

Net fund expense

Payroll service incorporation of a new vehicle

A GP should build its own comprehensive policy and formatting of such report. Likewise, a GP expense policy should be presented in a concise document summarising all internal procedures ruling a team's approach to engaging costs. Once defined and communicated it should not be changed for consistency reasons. An example of a GP expense policy key elements are:

- officers' remuneration and bonus system;
- travel-expense policy;
- individual financial authority;
- aborted-deals costs – allowance and approval; and
- administration and external-services costs approvals.

Portfolio performance

How can investors easily trace investment promises made after committing funds to the new investment?

Value progression for each transaction and historical lifecycle

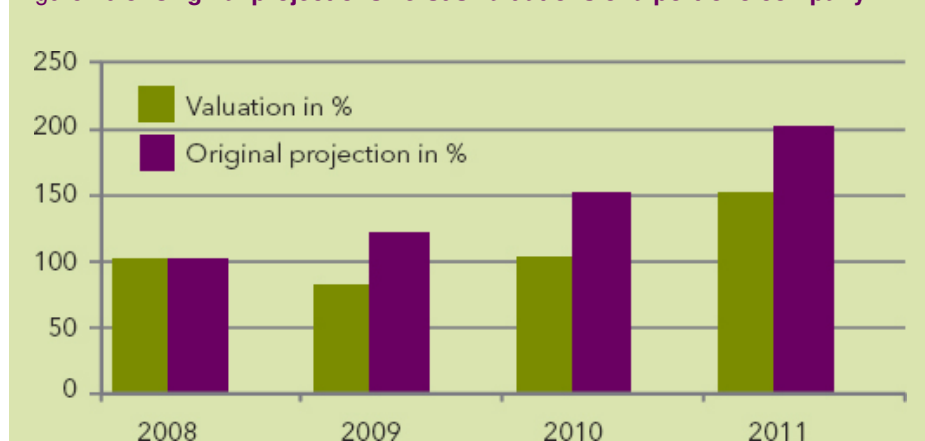
Through monitoring value progression benchmarked against the original projections. Since a portfolio company's lifecycle is always longer than the standard reporting period, showing the whole cycle can deliver interesting information about macroeconomic influences or the impact of operational successes and failures. Such information is included in regular accounting records but should be extracted for the longer period (this is represented in [Figure 19.3](#)).

Potential exit valuation

Providing potential exit valuations, as discussed in previous sections, might be an issue for many GPs. The reasons already highlighted relate either to regulatory limitations or an internal fund policy not to create investor expectation too early. Nevertheless, gaining an understanding of what could be expected from the investment and the

fund is a powerful tool in encouraging investors to reinvest in a GP's successor funds. How do GPs deal with presenting forecasts for future returns? It might be useful to show different scenarios, designed to give investors an idea about optimistic and pessimistic results achieved on each deal. An optimistic scenario allows for all favourable circumstances that help the business to grow faster than expected, while a pessimistic scenario is discounted for risks, market changes and macroeconomic crises. An important variable to consider when conducting this type of exercise is time, as the macroeconomic environment and investment microeconomics constantly change. Therefore, if a GP decides to present exit scenarios, these should be regularly revisited and considered as provisional values. Exit scenarios and regular valuations can only be prepared through the joint effort of an investment team and accounting staff. As with all forecasts, this is not a standard accounting record and cannot be accrued for and accounted for. This sort of information can be included in management reports, not financial statements.

Figure 19.3: Original projections versus valuations of a portfolio company



Investors can see the range of possible values and form an opinion about investment return potential through analysing optimistic and pessimistic scenarios.

Risk is a whole separate area of information of great interest to investors, but not a part of standard accounting reporting, although IFRS 7 requires some risk disclosures and presentation of sensitivity analysis. Presenting risk requires qualitative description of a problem and quantification of potential financial loss that might be incurred by the portfolio company. For internal GP portfolio-monitoring purposes, risks should be analysed and summarised on a risk map, which should

be created in the very initial phase of the investment and can be revised on a regular basis together with the portfolio company's management. This makes the GP fully aware of threats and allows for more informed management of consequences. There is no need to disclose such detailed information to investors, but it is critical that once a risk arises it should be communicated. If risk-mapping is properly performed and monitoring actually works, the GP should be able to communicate immediately the nature of the risk together with the underlying causes and the remedies undertaken.

Proactive risk communication primarily gives a strong impression of the GP controlling the situation and acting as a diligent manager.

GP team performance

Investment officers in a private equity fund have a similar role to top executives in other commercial organisations: they are responsible for marketing (promoting the fund to entrepreneurs); for investment (negotiating and closing transactions); and for sales (exiting portfolio companies). Along the way, they incur costs for third-party services, such as lawyer or consultant fees, as well as travel and accommodation.

Profit & loss for each investment officer

All these elements can form a standard profit & loss account produced by accounting that gives an individual profitability measure. Benchmarking these results against other team members provides an interesting ranking and gives a clear idea of seniority and competence.

Efficiency measures

In order to assess performance and efficiency, each private equity professional should be evaluated using two criteria:

- 1.The number of successful deals closed and exited.
- 2.The net profit achieved.

Both of these criteria can be measured and evaluated each year, but also over the lifecycle of every fund being managed. A report might be designed as in example report two.

Figure 19.4: **Example report two**

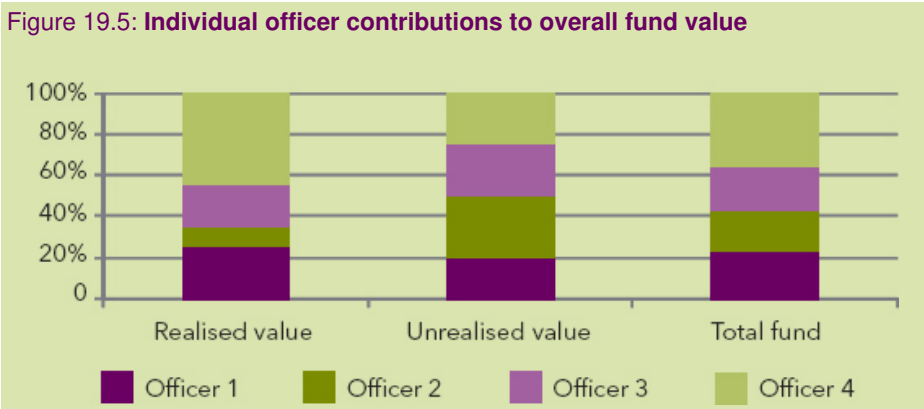
Investment officer	Number of deals closed	Net profit
John Smith	12	€100m
John Doe	10	€80m
John Brown	8	€60m
John Black	6	€40m
John White	4	€20m

A proposal such as the above report can be prepared readily by the accounting team, using standard portfolio records. The only potential change to existing records might be additional comment or classification by an officer.

In presenting data for selected staff members, the GP shows openness and helps investors map the team.

Team contribution to fund valuation

Valuation of a fund’s portfolio comprises two elements: realised and unrealised value of investments. Realised investment value equals actual proceeds received from the disposal of portfolio shares, while unrealised value is based on a manager’s valuation. To understand better which officers really contribute to the success of the fund, it would be useful to allocate relevant units of value to each person based on their personal involvement in managing each deal. The question that arises at this stage is how to present this value if there are several senior officers involved in developing one investment. Accounting standards usually solve this type of dilemma through allocation in proportion to the resources applied. This is neat and straightforward, but the key negotiation point between interested officers must of course be the percentage to be allocated to each of them. There is no other possibility such as mutual agreement, as this might become an additional evaluation discussion. An interesting outcome could be to compare such contributions (see [Figure 19.5](#)). There are some crucial questions to ask. Who contributes the most? Who delivers the most proceeds? Who closes the largest number of deals?



This additional reporting on individual performance might require a change in a GP’s internal procedures and may be rather unpopular.

Taking into account how strict private equity funds are with performance-reporting requirements from their portfolio companies, regular annual evaluations of top executives and exceptional focus on efficiency measurements for underlying management teams, it seems surprising to note the weakness in their own performance reporting to investors.

Changing the approach by offering individual performance reporting would certainly improve communication with investors and improve the internal understanding of value creation.

Summary

This chapter has presented the detailed reporting requirements that GPs need to be aware of and endorse in the intensifying level of investor-demanded information and greater need for quantitative and qualitative GP-to-LP communications. Specifically, the chapter has discussed in detail the role of investor relations professionals; a summary of investor meetings and events; reporting requirements for investor relations purposes; industry best practice and EVCA and BVCA reporting guidelines; and possible new solutions for accounting processes.

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In 2005, Monika was invited into the EVCA reporting guidelines taskforce as a representative of mid-market GPs. In 2000, she joined Innova Capital as a vice president of fund operations. In the role of supervisory board member, she was responsible for restructuring of many portfolio companies, leading to several successful exits.

Monika started her professional career as an auditor at Arthur Andersen in Warsaw and continued as a senior auditor with Salustro Reydel in Paris. In 1995, she assumed responsibilities of a financial manager at the Polish branch of Sanofi-Synthélabo, strongly contributing to the development of the firm into one of the top pharmaceutical players in Poland. She created a professional finance department, including accounting, controlling and treasury functions, building one of the first production-controlling teams in Poland.

Monika holds a master's degree in economics from the Warsaw School of Economics and a postgraduate diploma in psychology from the Warsaw School of Social Psychology.

Private equity accounting – the auditor's perspective

By Nat Harper, KPMG LLP

This chapter discusses:

- The limited partnership agreement
- Priority profit share
- Knowing what investments the fund owns and how
- Income recognition
- Spreadsheets
- Carried interest
- Investment valuations
- Limited liability partnership accounting
- Placement agent fees, asymmetric allocations and carry disclosure

Introduction

There are countless issues an auditor will come across during the course of the audit of a private equity house and its funds. Whereas the rest of this book covers various areas of private equity accounting this chapter does not seek to go into all of them in great detail, but it picks up on some of the areas that an auditor will generally focus on, with sufficient explanation of those areas and the reasons for focusing on them.

Not all of these issues will apply to all private equity houses and this is not an exhaustive list. Some of the issues are currently being debated by the industry and some will need detailed discussion between the private equity firm and its auditor to ensure correct treatment of the

various accounting issues. That said, this chapter provides a useful guide to private equity accountants and finance teams when preparing for the auditor's visit.

The auditor will probably set up the audit in two halves, focusing on the fund and the house's management companies. The management companies are likely to include a mixture of limited companies and limited liability partnerships (LLP) (see below) in some jurisdictions, such as the UK, and limited liability companies (LLC) in others, such as the US, with the usual accounting issues that these entail. These management companies might include the manager, adviser, founder partner and co-investment vehicles. The funds will consist of limited partnerships, with their own set of issues that an accountant will need to be aware of and that the auditor will focus on. The most important of these issues is referred to in the audit report, which might include an opinion such as the following:

"In our opinion the accounts for the year ended December 31, 2010 have been properly prepared, in all material respects, in accordance with the accounting policies set out in note 2 to the accounts and in accordance with the limited partnership agreement."

If there is one chief difference between accounting for a limited partnership and a corporate entity, it is the limited partnership agreement (LPA) that is the driving document and not the jurisdiction's company law. Even if the limited partnership were to prepare its accounts in accordance with relevant financial reporting standards and parts of company law, it is the LPA that would state this and any deviations allowed.

The LPA drives how the partnership is governed, accounted for and how the various partners are remunerated, among many other issues. It is the LPA that sets the rules, the LPA that the accountant needs to understand before he or she goes any further, and the LPA that the auditor of the funds will use as his or her starting point and will refer to throughout the audit.

Read, understand and implement the LPA

It may sound obvious but it is of critical importance to bear in mind that LPAs are often written with little regard for how their rules and mechanisms are to be accounted for and so can be unclear. Some partnerships in the private equity house's structure may have additional requirements for their accounts. A reconciliation of net

assets to US GAAP is a common one that can be missed.

With this in mind, on occasion, particularly with older LPAs, some clauses might be all but impossible to follow or at best extremely and unnecessarily complex. A typical example of this is in relation to carry calculations where some LPAs have pages of calculations to arrive at a position that other LPAs manage to achieve in half a page. In some cases, the LPA might actually be nonsensical.

Although thankfully increasingly rare, this does happen through poor drafting or simply incorrect definitions. Auditors see LPAs where following the actual written terms would lead to 80 percent of gains going to the carry partner (see below) and 20 percent to the limited partners – obviously not the intention of the LPA, not even when private equity firms could get the more generous terms commonly available a few years ago. In this case, consultation with the drafters of the LPA would probably be the way forward. It may be that agreement from the limited partners to an amendment to the LPA would be necessary.

As the private equity industry has matured, there are more established norms and standard terms, reducing the risk of the above happening. Despite this, it is a good idea to get feedback from your auditors when agreeing heads of terms and the eventual LPA to avoid problems arising later on.

Priority profit share (PPS)

In most limited partnerships in the UK, the general partner is paid for its management of the partnership and retains its unlimited liability, by way of a priority claim on the profits of the partnership. Unsurprisingly for such a key and material area, this PPS is something that the auditors will look at extremely carefully. It is, unfortunately, also an area that is from time to time incorrectly dealt with. [Chapter 12](#) includes a discussion of PPS in various countries – some jurisdictions treat PPS as a straightforward management fee. Before looking at the detail of calculating PPS over the life of the fund, it is worth looking at what usually happens at the beginning of the fund's life.

PPS recognised as if it were income and expense

In private equity, the nature of the investment means that in the early years of the limited partnership it is unlikely that there will be any profits available to pay the general partner. Therefore, an arrangement

is entered into whereby additional loans are drawn down from limited partners, over and above those needed for investment, in order to make a cash advance to the general partner of this PPS.

The technical issue is the accounting treatment for this advance of PPS both by the limited partnership and the general partner. In most instances, the following assumptions apply:

- The loan is only ever to be settled by allocation of future profits.
- The loan is interest-free.

The advance is treated in the partnerships as if an allocation were made on day one, that is, as if it were an expense in the period. Even if it were argued to be an asset/liability, since it is known that it will not be repaid, it would be considered impaired and is treated as turnover in the general partnership. In this situation, the general partnership may have an overdrawn partner's account, as it will still be paid the amount that would be due, but the partnership may not have sufficient income to 'clear' the balance. This negative balance is equivalent to a loan having been made. In the following year, assuming there is sufficient income, the partnership will allocate income both to catch up and to allocate for that year before income is allocated to the limited partners.

Calculation of PPS

There are two main considerations for the calculation of PPS: how its gross figure is calculated and how to treat any adjustments to it.

The gross calculation of PPS is usually split between the first half of the fund's life, that is, its investment period and the second half. During the investment period the PPS will probably be charged at a flat rate of 1.5 to 2 percent of the commitment size of the fund. For the second half of the fund the basis will normally change to actively invested capital. Usually, the gross calculation of this will be based on the acquisition cost of the unrealised investments, less provisions and write-offs. In both cases, this will give the headline PPS, which is then likely to be amended for investment-related fees received by the private equity house and abort costs incurred on failed deals. It is here that auditors will pay the most attention as it is here that there is most likely to be an error in calculation, or more specifically, attribution of PPS to each year.

In this example the following conditions are assumed:

Year	Two	Three
Headline PPS	£25,000,000	
Fees received	£2,800,000	
Abort costs	£15,000,000	

PPS is sometimes notified to the limited partners taking into account fees earned and abort costs suffered in the previous period, but problems often arise where, as in this example, PPS is drawn from the limited partners quarterly, in advance. Here, as usually occurs, fees are received by the house and abort costs are fully charged to the fund. The LPA states that these will be shared on an 80/20 basis, that is, via the PPS amendment, or rebate, the fund should receive 80 percent of the fees received but suffer 80 percent of the abort costs incurred. This would usually be set out in the following formula:

$$\text{Rebate} = \text{abort costs} + ((\text{fees} - \text{abort costs}) \times 80\%)$$

The problem arises with the fact that the PPS is drawn down in advance and therefore will not reflect fees received and abort costs suffered during the period it covers. In addition to this, it can be difficult for the accountant preparing the calculation to have a clear view of all the abort costs that he should be including.

Assuming for the sake of argument that all the fees received and abort costs have occurred during the fourth quarter in year one, but in the second quarter in years two and three. The last drawing down of year one PPS would have been on October 1, with no rebate applied to it or the preceding quarters' notices. As such, an adjustment is going to be needed to the year two first quarter PPS invoicing to cover the fourth quarter movements. This amount of £2.5 million should be deferred to the balance sheet in both the fund and the general partnership, as it is in effect overpaid PPS. This will then unwind over year two as further PPS is levied. (See [Table 20.1](#)).

Table 20.1: Fees and costs impact on PPS

	Total	
	Three	
Headline PPS	£25,000,000	
Fees received	£2,800,000	
Abort costs	£1,000,000	
Rebate	(£2,200,000)	
PPS P&L charge	£88,800,000	
PPS cash paid	£88,800,000	

The difficulty associated with this is ensuring that all fourth-quarter abort costs are captured by this adjustment. It is important that there is good communication from the investment executives, probably managed by the finance director as he is likely to be included in their deal meetings on deal activity. Costs that have been incurred or accrued by the investment committee should be included in the fund's accounts and therefore in the rebate calculation. It is common for a view to be taken on what percentage of costs incurred are likely to end up as abort costs based on previous deals. However, each deal should be considered carefully to ensure that all adjustments to PPS are captured.

There are two main areas that might give rise to error. Firstly, where PPS is not correctly deferred to the following year, sometimes because of the belief that the cash paid should be the same as the PPS charged. As can be seen in [Table 20.1](#), this is true over the life of the payments. In this example, year one features an overpayment of cash; year two features a release of the deferred PPS and a large drop in cash paid to reflect this, along with an adjustment for the year two rebate items. By the end of year two the cash payments and profit & loss charge are synchronised, as there are no fourth-quarter adjustments to be made, and because the same holds true in year three, the cash paid in year three equals the profit & loss charge as the second-quarter adjustments can be made in the third quarter.

Secondly, where abort costs are not correctly included due to poor communication between the front office and back office of the private equity house or between the house and the administrator. It is not helped by the fact that deal costs are often not invoiced until the deal has completed or fallen over. It goes without saying that there should always be good communication between front office/back office/administrator, but it is critically important here, where the accountant is directly dependent on the activities of the front office in order to account correctly.

There is another, extremely important, area where this link is absolutely vital.

Knowing what investments the fund owns

Another area that auditors will focus on is what investments the fund owns and the structures through which it owns them. It may not seem a particularly contentious area – it is after all usually hard to miss a fund making or disposing of an investment. However, it is not quite that

simple as there will be complex holding structures often across various jurisdictions, which may well change after the initial deal completion for a variety of regulatory and tax reasons or for follow-ons. Each deal will probably have a different structure depending on the different requirements of the parties involved in that deal and it is likely that at least some of the holdcos and midcos in the structure will not require an audit, which can lead to less attention being paid to them that might otherwise be the case.

The accountant needs to work closely with the deal team to ensure that the back office is sure of precisely which companies and instruments the fund owns at any point in time. The finance team should ensure that structure charts are kept for each investment and kept up to date. This is even more important where an administrator is used.

There are many potential mistakes that can be made through incorrect tracking of this, but aside from the obvious implications for fixed assets in the balance sheet, it can lead to the incorrect recording of cash flows and income up through the holdco groups, and in some circumstances cash being missed and not returned to investors.

Where investment holding structures have changed, for example because of a refinancing, the accountant should ensure that each part of the change is correctly reflected – for example it may involve the realisation of some of the original cost or the receipt of investment income, which may or may not have been accrued for. This leads us onto another important part of the audit of the fund's financial statements – that of income.

Income recognition

Unless a limited partnership is preparing full GAAP accounts, income recognition can be treated in two ways, that is, either on a cash basis or an accruals basis.

Industry practice has moved away from cash accounting to accruing for income, although cash accounting is still fairly common. Either way there is a close relationship between income recognition and the partnership's policy on investment valuations.

In the past, a common practice was to cash-account and hold investments at impaired cost. If the fair values of the investments were included at all in the accounts then they would just be as a disclosure note. These fair values would include accrued income where it existed

but this would not be passed through the primary statements.

Table 20.2: Valuation example	
	Fund's 60% holding
	£m
EBITDA	100
Multiple	8
Gross EV	800
Net debt and other adjustr	(200)
Net EV	600
Loan stock	(300)
Interest thereon	(50)
Value attributable to equity	250
	360

In [Table 20.2](#), where the fund's cost of investment is £200 million, no income would be booked to the balance sheet until the investment is realised. It can be seen that the interest accruing on the loan stock of £30 million enters the calculation above the equity.

If, however, the accounting policy is to fair-value investments, then care must be taken not to double count this income. The interest accruing on the instruments is wrapped up in the fair value and so there should not be an interest accrual as well.

This accrual of income is another area that auditors will focus on and is linked to the extent to which the house and/or administrator has a firm understanding of the precise instruments owned by the fund. The finance team should be reviewing the interest accruals on the interest-bearing instruments and ensure that they are being correctly recognised. This can be done on a simple control spreadsheet, which, however, is unfortunately an area where errors can all too frequently arise.

Spreadsheets

Spreadsheets are an important part of the life of any finance team. They are used to record journals, keep internal records and often produce investor reports and final accounts among a host of other tasks. Their simplicity and ease of use comes with both advantages and disadvantages.

Given the special nature of private equity accounting, particularly in relation to partnership accounting, and the relatively small size of finance departments, many houses will not have large bespoke pieces

of software designed for their specific needs. They will tend to use standard software, perhaps adapted a little where possible and rely to a large extent on spreadsheet control. These spreadsheets will be used to keep records of things such as the carry and PPS positions of the fund. The auditor should go through the workings of these spreadsheets very carefully to ensure that the way they are set up matches the requirements of the LPA. The spreadsheet needs to capture all money flows, on the correct dates, between the correct parties and obviously needs to be internally consistent and mathematically correct. The potential for error when implementing this should not be underestimated.

Tiny errors in the spreadsheet can snowball into large differences when extrapolated across the entire fund over several years. A simple mistake in the internal rate of return (IRR) calculation, or allocation of profits between partners, can lead to embarrassment, especially if the house has mistakenly taken more than its fair share from the investors. You can be sure that although there may be many amendments to PPS each quarter that go unchallenged by investors, an amendment because of an error is sure to spark someone's attention.

Carried interest

Along with PPS and investment valuations, this is one of the 'big three' areas of the fund accounts that are likely to be of most interest to the user and to the auditor. As described in more detail elsewhere in the book, while the management fee is the amount charged for the day-to-day running of the house and administering of the fund, the carried interest is the profit share paid to the house executives to ensure that their interests and those of the limited partners are aligned.

The LPA will state in detail the terms of the carry – how it is calculated and when it should be allocated and paid. The accountant must be aware of these precise terms, not least whether it is calculated on a deal-by-deal basis or on a whole-fund basis, where the entire investment of the LPs in the fund is used in the calculation. There may well be various idiosyncrasies depending on the exact situation of the partnership, but nowadays most clauses should be similar to the following example.

Here, no carry is allocated to the carried interest partner (CIP) until the limited partners have received their cost back, plus the hurdle of 8 percent as calculated at each repayment point. At this point, the CIP is then entitled to 25 percent of the income until it has received 25

percent of the 8 percent hurdle. Thereafter the income is split 80:20 for the limited partners and CIP, respectively. This is known as 8/20 and is the most common arrangement in private equity funds extant today. See [Table 20.3](#).

The auditor will be looking to ensure that the spreadsheet is correctly set up, specifically that the IRR is being correctly recalculated at each repayment point, and that the cash flows being used in the calculation agree to those specified in the LPA. It is a useful check to have a set of instructions on how the spreadsheet works, with corresponding extracts from the LPA to ensure that all requirements of the LPA are covered and that the spreadsheet is accurate and complete.

Table 20.3: Carried interest worked example			
£	LP loans & CIP repayments	LP payments	
Drawdown	Jan 5, 2010		
Hurdle c/c	July 3, 2010		
Income	4,387		
Hurdle c/c	Sept 3, 2010		
Realisation	(2,500)		
Hurdle c/c	Jan 2, 2011		
Income	2,350		
Hurdle c/c	Sept 1, 2011		
Realisation	(2,350)		
Catch-up carry			
(445 x 2%)	Sept 1, 2011		
Profit allocation			
Carry payment - 20%			
(890 - 44) x 20%	Sept 1, 2011		
LP - 80%			
(890 - 445 - 111) x 80%	(267)		
	(5,400)		

The auditor will also review what the situation is regarding clawback, that is, what happens to the fund if it reaches a position where carry is payable but then falls back below the hurdle, or if clawback across different deals applies in a deal-by-deal carry situation. Again this will be explained in the LPA, and there are a variety of treatments, so do not just assume that one partnership in a fund is the same as another partnership in the same fund, let alone in an entirely different fund.

There is often confusion over whether or not to accrue for carry in the accounts prior to the hurdle being hit, and, if not, what to disclose. The simple answer is that carry should not be accrued for before this. The usual practice is to have a disclosure note showing the effect of what would happen if the balance sheet were realised at the investment values shown if that would trigger carry. This note might state

something similar to:

“If the fund’s investment were to be realised as at the balance sheet value, the founder partner would be entitled to an allocation of £x as per the terms of the limited partnership agreement.”

Once certain investments are realised and physical cash has been distributed to the LPs pushing through the hurdle, there is an obligation to pay the carried interest on all future realised investments.

Carried interest is then allocated to the CIPs in the partnership financial statements for all realised and unrealised gains on investments. This is initially shown by reallocating a proportion of the historic gains realised to the CIP in the partners’ accounts (the analysis of capital contribution, loan balances and profit & loss). In the event that a revaluation reserve has been accumulated for unrealised profits, this should be allocated similarly.

Valuations of investments

This is a crucial area of nearly all partnership accounts and one that the auditor will scrutinise very carefully. It is probably also the only area where he will spend large amounts of time with the deal executives, in order to understand the position of the investments.

Equally, it is probably the area of the accounts where back office and front office will work closest together, as the valuation is likely to be a joint effort between the relevant executive and the finance team. Communication and open discussion between all three parties during the audit is paramount.

Industry practice has been to move away from holding investments in fund accounts at impaired cost to fair value. Obviously where a formal GAAP is being adopted by a limited partnership, then the strictures of that GAAP are what need to be followed.

The most common method in the UK and Europe to arrive at a fair value for investments is to value them in accordance with the *International Private Equity and Venture Capital (IPEV) Valuation Guidelines*. Following these should result in a valuation compliant with UK GAAP, IFRS, and US GAAP. The auditor’s focus therefore is on compliance with these guidelines. Some of the key areas that the auditor will focus on, and that the preparer of the valuation is likely to be challenged on are as follows:

1.Method of valuation: The auditor would expect in most cases to see an earnings based valuation being used, as suggested by the IPEV Guidelines. Cost of recent investment may be appropriate for a certain period of time after the initial investment has been made or if there is a further investment or a secondary transaction. However, great care must be made in these circumstances that the transaction is representative of the fair value of the investment; factors specific to the transaction, such as a distressed situation, may well mean that is not. It should be noted that if investments are held at fair value, then even at the beginning of their life they are not held at cost for 12 months, six months or any other period of time. It is simply that the cost of the investment is still considered to be the best indicator of fair value at that point. Other methods may be suitable depending on the type of investment, for example, an asset-based valuation. Discounted cash flow (DCF) models can be useful as a sense-check, but are only sometimes suitable as a primary means of valuation, not least because they are so subjective and it can be extremely difficult to gain comfort over the myriad assumptions included in the model.

2.Earnings: When an earnings-based model is used, the earnings (usually EBITDA) must be maintainable. It is not a problem to have adjustments to management reported EBITDA, but these adjustments must be reasonable and explicable. Some blend of past and forecast EBITDA may be one way of achieving an EBITDA that is representative of the business's position and growth. Future, speculative cost-cutting programmes are an example of something that should not normally be reflected here. As always when preparing a fair value valuation, it is important to bear in mind what is likely to be considered as reasonable by the parties to the transaction if the investment were being disposed of.

3.Multiple: The multiple being applied to the earnings of the business in order to arrive at its gross enterprise value is arguably the most important part of the whole valuation process. As in a transaction, this is the number that will be stressed to reflect all the different aspects of the company's position and performance in relation to the multiples of the comparative companies chosen – its quality of management, of earnings, the diversity of the markets it operates in, the liquidity of the fund's holding of it inter alia, collectively known as the 'points of difference'. Until 2009, the IPEV Guidelines suggested that a liquidity discount be applied to the final valuation of the investment, usually in a range of 10-30 percent depending on the percentage holding of the investment. This approach has now been removed and replaced with the principle that a discount for liquidity, or marketability, should just be

one of the many points of difference applied to the multiple at this stage of the valuation. This change removed the last major difference between the guidelines and US GAAP compliance.

4.Adjustments to gross enterprise value:The auditor will scrutinise these to ensure that they are adjustments that appear reasonable and might be expected in a sales process. For example, the deduction of a correctly estimated pension deficit or the addition of cash only when it is excess to working capital.

5.Allocation of value to instruments: This should not be too complex as it is merely a case of applying the value obtained above down the ranking of instruments. The estimation of fair value should assume that any options, ratchets and warrants are exercised where the fair value calculated would trigger them. As a general rule, the most likely scenario should be assumed and apportionments and calculations made based on that scenario. As mentioned above, it is important to ensure that the accrual of income is correctly reflected – that it is not ignored and not counted twice. Your auditor will probably have seen both happen.

Foreign Exchange

The impact of foreign exchange on valuations is something that is not always fully understood. In practice, the debt and equity elements of an investment are considered together as a package. The overall impact of the currency on the value of the investment is considered as a part of the valuation process and included within the overall increase or decrease in valuation. It is reasonable to consider these different instruments as a single package as that is the way the investment was made and will probably be realised. In the event that a part of the investment is refinanced, the impact of currency movements must be considered at that stage.

Particular care is required where investee companies are based in emerging markets with volatile currencies to consider whether there have been any post-balance sheet events that have a significant bearing on the currency and accordingly the investment value.

Table 20.4: **Foreign exchange in a valuation**

Expenditure	Enterprise
£10,202,000	
£8,925,000	

A key point is that if an investment's cost is still considered the best indicator of fair value and that investment has been made in a foreign

currency, then it should still be retranslated at the year-end. This is illustrated in this example.

LLP accounting

LLPs are often used as the adviser of a UK private equity house, giving advantages to succession and tax planning for the partners of the house. Being somewhere between a limited partnership and a limited company, most of the accounting in an LLP is the same as the accounting for a corporate entity. However, there are a few areas that an auditor will look into specifically.

The LLP is subject to most of the UK Companies Act, but its financial statements are also prepared following the *LLP Statement of Recommended Practice* (SORP) issued by the Consultative Committee of Accountancy Bodies. This provides guidance on how to apply the Companies Act and the Financial Reporting Standards to LLPs. The LLP's financial statements will contain a statement declaring that they have been prepared in accordance with SORP. The following issues can crop up in an audit of an LLP.

Classification of debt and equity

The release of FRS25 changed the picture for LLPs, with new definitions about whether the instruments issued by the LLP should be classified as debt or equity.

The guidance given in SORP is helpful here:

“Under FRS 25 and UITF 39, a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to deliver either cash or another financial asset to another party. Critical, therefore, to determining whether the LLP has a financial liability to a member, or alternatively the member holds equity in the LLP, is whether there exists a contractual obligation on the part of the LLP to deliver cash (or other financial assets) to the member – for example, on the member retiring from or otherwise leaving the LLP. Generally, a member's participation right will result in a liability unless either the LLP has an unconditional right to avoid delivering cash or other assets to the member (that is the right to any payment or repayment is discretionary on the part of the LLP).”

Therefore, funds contributed to the LLP that figuratively speaking a

partner is able to walk into the bank and withdraw when he wants to should be classified as debts due to members in the LLP's financial statements. If he is unable to do so without the permission of the LLP or a board representing the LLP then it should be classified as equity. There should be some of the latter if, as is usually the case, the LLP is Financial Services Authority-registered, as an amount will need to be retained at all times to meet its regulatory capital requirements.

Classification of profits

The above guidance is also helpful in deciding how to reflect profit allocations to members of the LLP. The simple fact is that anything that can be considered a non-discretionary payment, for example a monthly salary or interest on contributed capital, should be treated as members' remuneration treated as an expense in the profit and loss account. The direction given by SORP on profit distributions is worth quoting at length here:

“Where profits are automatically divided as they arise or are determined, so that the LLP does not have an unconditional right to refuse payment, the amounts arising that are due to members are in the nature of liabilities. They should therefore be treated as an expense in the profit & loss account in the relevant year and, to the extent they remain unpaid at the year end, they should be shown as liabilities in the balance sheet. Conversely, where there is no automatic division of profits the LLP has an unconditional right to refuse payment of the profits of a particular year unless and until those profits are divided by a decision taken by the members (or a committee of the members to which the authority to divide profits has been delegated); and accordingly, following such a division, those profits are classed as an appropriation of equity rather than as an expense. They are therefore shown as a residual amount available for appropriation in the profit & loss account. Once profits are divided, the amount of the divided profits is treated as an appropriation which is deducted from equity, and, to the extent that any divided profits remain unpaid at the year end, the amount unpaid will be recorded as a liability.”

Using the above, and assuming the following, you would end up disclosing the bottom of the profit & loss account and the members' interests note as follows:

Profit for the year	£100,000
Members' salary	£10,000
Members' drawings	£40,000

The drawings should reflect the cash paid to the members, regardless of how much in the current year has actually fallen due to them.

Table 20.5: LLP profit & loss account extract

£'000
Profit for the financial year before members' remuneration
Members' remuneration charged as an expense
Profit for the financial year available for distribution

Table 20.6: LLP members' other interests

	Members' capital classified as equity	Other reserves	Total	Loans and other debts due to members	Total
	£'000	£'000	£'000	£'000	£'000
b/f	50	15	65	10	75
Members' remuneration charged as an expense	-	-	-	10	10
Profit for the year available for discretionary division amongst members	-	90	90	-	90
Members' interests after profit for the year	50	105	155	20	175
Other division of profits	-	(35)	(35)	35	-
Drawings	-	-	-	(40)	(40)
Amounts due to members	50	70	120	15	135

It happens, however, that a member will withdraw more than he is entitled to and so owes funds back to the LLP. There is nothing inherently wrong with this (although it may of course lead to other problems if other reserves are not sufficient) but SORP is quite strict on the disclosure requirements.

Amounts due to and from members may not be offset unless they are in relation to the same partner and meet the criteria of FRS25 surrounding rights of set-off.

Assume in the above example that one of the members overdraw by £3,000 by, in effect, anticipating profits not yet allocated to him. The auditor will expect to see the example illustrated in [Table 20.7](#) over the page.

On the balance sheet, this balance should be shown separately in

debtors, with the bottom part of the balance sheet showing as illustrated in Table 20.8 over the page.

Table 20.7: LLP members' interest

	Members' capital classified as equity	Other reserves	Total	Loans and other debts due to members	Total
	£'000	£'000	£'000	£'000	£'000
b/f	50	15	65	10	75
Members' remuneration charged as an expense	-	-	-	10	10
Profit for the year available for discre- tionary division amongst members	-	90	90	-	90
Members' interests after profit for the year	50	105	155	20	175
Other division of profits	-	(35)	(35)	35	
Drawings	-	-	-	(40)	(40)
Amounts due to members	50	70	120	15	135
Amounts due from members	-	-	-	(3)	(3)
c/f	-	-	-	-	132

Table 20.8: LLP balance sheet extract

	p/yr £'000
Net assets attributable to members	1750
Represented by:	
Loans and other debts due to members	
Other amounts	16
Other interests	
Classified as equity under	50
Other reserves	76
Total members' interests	126
Amounts due from members	(3)
Loans and other debts due	16
Members' other interests	133
	132

There are of course many other aspects to the LLP SORP, but these are the areas that are most frequently queried by preparers of LLP accounts.

Placement agent fees

Sometimes managers contract with placement agents to source investors for potential new funds. There is often confusion about how to treat these, that is, whether they should be expensed as incurred or capitalised and amortised and if so over how long.

UK GAAP

The manager may be required to pay the placement agent irrespective of whether sufficient investors are sourced or not. How should these costs be accounted for by the manager? Assets are defined as “rights or other access to future economic benefits controlled by an entity as a result of past transactions or events”. Where it is only possible that the investors will be found when the fee falls due there is no control over future economic benefits. At this point costs incurred do not necessarily give rise to rights or access to future economic benefits that are controlled by the entity.

UITF 34 offers guidance on pre-contract costs and states that costs incurred before a contract is virtually certain should be expensed, whereas directly attributable costs incurred after that point should be recognised as an asset.

The exact point when the award of a contract becomes virtually certain will depend on the particular circumstances of the case, but a large part of the placement agent fees are often dependent on the signing-up of the investor. Each case must be considered on its own merits and particularly the follow key points cleared:

- Are the placement agent fees only payable on investors signing up to the fund?
- Is the investor committed to paying an annual fee?

On these bases, subject to the appropriate audit consideration and judgement, it should be possible to conclude that the placement agent fees may be included in the balance sheet.

What is an appropriate amortisation period?

The life of the fund is established by the LPA and is usually eight to ten years, extendable by the general partner for two more years and thereafter by agreement of the LPs.

The manager will usually receive fees at a rate of 1.5-2 percent of the commitment in the investment period and on the basis of book values

thereafter. Income to the manager is effectively guaranteed for the investment period and reducing to zero over the remainder of the fund, so the investment period might be a reasonable time over which to amortise the asset.

IFRS

IAS 18 considers investment management fees and states that incremental costs that are directly attributable to securing an investment management contract can be recognised as an asset if they can be identified separately and measured reliably, and if it is probable that they will be recovered. This is generally the basis used by those fund managers that carry the fees on the balance sheet. However, there is uncertainty over the present and future position under IFRS, as the currently issued exposure draft on revenue recognition does not refer to this specific situation. IASB is currently revisiting the exposure draft and there is a possibility that this might change.

Asymmetric allocations

This is an area that can lead to difficulties for the accountant when preparing the accounts and for the auditor when auditing. It arises when one or more limited partners interests in the partnership in different proportions from the others – for example, if they are excused from investing in a particular investment.

It is imperative that separate records be kept for each limited partner to ensure that their interests are correctly tracked. Care must also be taken around any carried interest allocations to ensure that the LPA is correctly followed, as it must be ensured the limited partners in question are not unfairly penalised if indeed the LPA allows for this flexibility. The carry model will by necessity be much more complicated if the hurdle needs to be calculated both on an investment and a limited-partner basis. As mentioned earlier, in this situation it is worth asking your auditor for feedback when setting up the carry model and other spreadsheets to ensure that the requirements of the LPA are correctly applied.

Related-party disclosures in the manager's financial statements

Given the complexity and variety of some private equity structures, it

can be difficult to ensure that all significant related-party transactions are captured in the manager's accounts.

Assuming a standard private equity structure, where the fund has a general partner and carried partner that are owned by the manager, the manager's accounts will need to ensure sufficient disclosure of the relationships and any payments made by the fund.

This is potentially a complex area, with many different arrangements meaning that there is a range of scenarios, but given the standard arrangement, it would be normal in both UK GAAP and IFRS accounts to see disclosure (in aggregate only) of the amount of carried interest paid to the CIPs where they are related to the house, which in a standard set up they would be.

Minimum disclosure should include the amount paid, the relationship of the carry entities to the LLP, and how and why these amounts are received by the carry entities.

Summary

As mentioned in the introduction to this chapter, this cannot hope to be a comprehensive study of every issue that the auditor might find when auditing a private equity house, but it has focused on the areas that arise most often, that is, the areas that the auditor is likely to expect to have to spend the most time on.

All points apply to houses with in-house and outsourced back-office functions, but the use of an administrator can lead to a greater risk of a breakdown in communication somewhere along the line. Having a thorough understanding of how all parts of the house function, particularly the LPAs and the investment structures, should lead to an easier time for the accountant, administrator and auditor.

This chapter has considered:

- The LPA and how it is imperative that it be fully read and understood
- PPS, its treatment in the first years of the fund and common difficulties in calculating and allocating it
- Knowing what investments the fund owns and critically how
- Income recognition, how it links with the investment valuation and the risk of double-counting
- Spreadsheets
- Carried interest, its calculation and the importance of getting it 100

percent right

- Investment valuations including foreign exchange
- LLP accounting – the debt/equity split of capital and treatment of profits
- Placement agent fees, asymmetric allocations, and carry disclosure

The most important point of all of these is read and understand the LPA!

NB: the source of all tables in this chapter is the author, Nat Harper.

***Nat Harper** is qualified as a chartered accountant with the Institute of Chartered Accountants in England and Wales, and has worked for KPMG in its Private Equity Group in London since 2006. Nat has a range of clients, from small UK-based venture capital firms to global large buyout houses. Nat provides them with a wide range of audit and assurance services including statutory audits of their management companies and LLPs and non-statutory audits of their funds and carried interest vehicles. He is also heavily involved in working on his clients' track-record reviews and carry-payment calculations, as well as reviewing private placement memoranda and advising on structuring and the provision of various other fundraising-related services. A large part of his work is reviewing clients' valuations for compliance with the International Private Equity and Venture Capital Valuation Guidelines. Outside of the office he enjoys sport, reading, history and the local pub, but not in that order.*

Appendix I

Private equity fund structuring

By Private Funds Group, Clifford Chance LLP

Introduction

Those unfamiliar with the asset class often make the mistake of thinking of private equity funds as a straightforward product, conforming to a standard model. While many of the economic fundamentals (most notably the 20 percent carried interest) have generally remained consistent since the origins of the industry, constructing private equity fund structures is a bespoke and complex task. The increasing popularity of private equity funds during the boom has led to greater variety of investors and investment strategies, as well as a proliferation of fund managers and sponsors based in jurisdictions which were not traditionally associated with private equity activity. The more recent downturn following the global financial crisis has also had an impact: as capital has become scarce managers have necessarily become more accommodating of investor demands. The break-up and restructuring of management teams and businesses have also demanded changes to the legal structures on which they are based. Even for managers with stable businesses, changes in the regulatory and tax environment have led to existing structures being reconsidered. These are all significant factors in determining optimal structuring solutions. The Alternative Investment Fund Managers Directive is still some way from implementation, but managers are already considering how it will affect their future operations; the optimal structure for any fund will need to take account of this.

Basic structuring considerations

Any fund structuring involves a careful consideration of a number of factors, including:

- tax transparency of the fund vehicle, tax position of the target investor base generally and tax treatment of the fund's target assets;
- limited liability for both manager and investors;
- regulatory issues, including whether the manager and/or the fund need to be authorised or regulated;
- whether the proposed structure achieves a commercial alignment of interests between managers and investors;
- location of the management team(s) and whether management fees and performance fees/carried interest can be structured in a tax-efficient manner;
- nature of the co-investment arrangements for the manager and/or related individuals;
- permanent establishment and other operational issues;
- negative investor and tax authority attitudes towards vehicles established in or operated from certain jurisdictions and, conversely, familiarity with and confidence in vehicles established in or operated from others;
- flexibility to permit transaction-specific structuring below the level of the fund; and
- cost and timing.

Types of vehicles

There are a number of vehicles which satisfy many of the structuring challenges involved in establishing private equity funds. Some of the features, attractions and limitations of each are discussed below.

The choice of vehicle will depend in large measure on the location and status of the investor base and it is likely to be difficult to select the most appropriate vehicle without an informed view of the types of investors who are likely to commit to such a fund. It may also be that rather than selecting one such vehicle, a combination of vehicles is used, either investing in parallel or through the use of a master/feeder fund structure.

The use of parallel fund entities complicates the investing process because of the need to rebalance among the fund entities upon subsequent closings, the increased complexity in shareholders/fund agreement terms and the need to divide costs among the fund entities.

However, despite the additional cost and complexity which this brings to the equation, this is becoming increasingly common, with fundraisers keen to appeal to a wide range of investor types.

Broadly speaking there are three general categories of vehicles which can be used as the main building block in any private equity fund structure:

- limited partnership and the fund for joint account (French FCPR, Luxembourg FCP, Spanish FCR, Dutch FGR);
- taxable corporate; and
- tax-exempt corporate.

The limited partnership and fund for joint account

The limited partnership (or, in certain jurisdictions, the broadly equivalent concept of a fund for joint account) is generally regarded as the predominant private equity fund vehicle. Limited partnerships may be formed under the laws of a variety of jurisdictions including England, Scotland, Germany, Spain, the Netherlands, Jersey, Guernsey, Cayman Islands and Delaware.

Advantages

Although the precise characteristics of these entities can vary according to the law under which they are formed, the advantages and attractions of a limited partnership or equivalent structure are discussed in the following sections.

Limited liability for investors

These entities offer limited liability for investors, provided, generally speaking, that they do not take part in the management of the limited partnership.

Tax transparency

Generally a limited partnership will not be treated as a separate taxable entity and therefore operates as a 'flow-through' so that distributions are treated for tax purposes as if they had been remitted to the limited partners directly, allowing limited partners to receive the benefits of any foreign tax credits and/or lower rates of tax applicable to capital gains.

No withholding tax or capital duties

Limited partnerships or equivalent partnerships are generally not subject to withholding tax or capital duties. However, in the context of pan-European real estate fund structuring, partnerships established in Jersey, Guernsey or any other jurisdiction with which France does not have a double taxation treaty may be subject to an annual 3 percent

tax on the value of their French real estate investments.

Flexibility

Partnership law is generally very flexible and these vehicles tend not to be heavily regulated by statute by comparison to, say, corporate vehicles which are often subject to detailed rules in respect of, for example, shareholder participation, amount of paid-up capital required on subscription and distributions. This flexibility allows for considerable latitude in negotiating and drafting complex arrangements, for example, with regard to fee-and profit-sharing arrangements and leverage at both fund and transactional levels.

Management

As the limited liability of each limited partner depends on it not becoming involved in management, there is less room for a limited partner to try to become actively involved in investment decision-making or running the fund. This is often seen as an advantage by managers but clearly may, depending on the relationship between the parties, be a drawback in meeting commercial objectives in certain cases. This is particularly the case in recent times, as managers and investors explore co-investment and club-like arrangements that may give key investors more control over the underlying assets.

Disadvantages

There are also a number of drawbacks associated with a limited partnership or similar structure, which are discussed in the sections that follow.

Transparency

While most countries do regard limited partnership and equivalent vehicles as transparent, this is not always the case and parallel/ alternative structures may need to be used in certain jurisdictions. (The position of French investors receiving foreign-source income through partnerships is a case in point although an evolution of this position is expected.)

European Union Parent/Subsidiary Directive

It will not be possible for a limited partnership and equivalent vehicle to take advantage of the European Union (EU) Parent/Subsidiary Directive, which exempts dividends from withholding tax and corporate tax, although subsidiary companies owned by the limited partnership and individual investors in the limited partnership may be able to do so.

Double tax treaty protection

It will only be possible to rely on double tax treaty protection to the extent that the underlying investor is able to do so, although sub-fund structuring (using, for example, Dutch or Luxembourg holding company entities) is usually employed to minimise withholding and achieve other tax objectives.

Although it is possible to generalise about the features of limited partnerships and their equivalents as a type of fund vehicle, it is important to bear in mind that there can be significant differences between limited partnerships and their equivalents established in different jurisdictions when designing a structure. Their key features are surveyed below.

Delaware limited partnerships

Many US-based funds have been structured using Delaware limited partnerships (DLPs). In addition to the advantages noted above for partnerships generally, specific advantages in relation to DLPs include:

- Delaware has well-developed case law which allows the partnership agreement to be enforced to the maximum extent.
- The Delaware statute provides for limited statutory clawbacks of distributions, safe harbour activities in which a limited partner may participate without risking its limited liability and the ability to determine the general partner (GP's) fiduciary duties through contract.
- There is no obligation to disclose publicly the terms of the partnership agreement, the identity of the partnership's limited partners or the partnership's accounts (but such information may nevertheless be required to be disclosed by a governmental investor under freedom of information legislation).
- There is no need to maintain an office or personnel in Delaware or in the US.
- Organising a fund as a DLP can be accomplished quickly and at little cost, and annual Delaware taxes and registered agent fees normally are approximately \$550.
- US investors are familiar with Delaware partnerships.

Specific disadvantages include:

- Non-US sponsors may be reluctant to use a US-law vehicle because of concerns about lawsuits (the US courts have tried a significant number of private equity fund related cases, generating a body of case law which is not mirrored in other jurisdictions) or

becoming subject to US regulations.

- Somewhat more restrictive guidelines apply to avoid registration of a DLP and its limited partnership interests with the US Securities and Exchange Commission than apply to non-US entities.
- A DLP must file US partnership tax returns (although non-US funds with US investors also often agree to file US partnership tax returns), and will be treated as a 'United States person' for purposes of applying various US tax rules to investments in non-US companies.
- Non-US investors may be subject to internal investment restrictions which require that the fund vehicle is, for example, an EU entity.

English limited partnerships

In Europe, one of the most regularly used limited partnership vehicles is an English limited partnership (ELP) established pursuant to the Limited Partnerships Act 1907. ELPs have all of the benefits noted above for partnerships generally. ELPs are tax-transparent for UK tax purposes and therefore capital gains generated by the partnership can be distributed as such to investors and holders of carried interest entitlements.

In the UK, this capital gains tax treatment for carried interest has been confirmed in practice by the 1987 British Private Equity and Venture Capital Association (BVCA) Statement (agreed with the Inland Revenue (now Her Majesty's Revenue and Customs) and as amended significantly by more recent memoranda), provided certain conditions are met. The statement also confirmed that the switch in private equity waterfalls from hurdle to carried interest would trigger a base-cost shift, ensuring that executives entitled to carried interest inherit part of the base cost of other investors thereby reducing the liability of these executives to capital gains tax.

These 'first principles' have ensured that carried interest structures consistent with the BVCA statement have often compared favourably to other executive incentive mechanisms, such as straightforward bonus schemes, which result in executive bonus payments being subject to income tax and their employers being obliged to make national insurance contributions. In addition, they compare favourably to the tax treatment afforded in other jurisdictions, for example, to US executives under US structures and in particular when compared to continental European jurisdictions where achieving capital gains tax treatment (and thereby avoiding carried interest returns being characterised as employment income triggering social security charges

to executives or their employers) has involved careful planning, with the end results not always beyond attack from domestic tax authorities.

Unlike DLPs, the GP and/or manager of an ELP operating the ELP from the UK will need to be regulated by the UK Financial Services Authority (FSA). An offshore GP and/or investment manager, operating the limited partnership fully outside the UK will not need to be regulated by the FSA in relation to that activity. However, it may need to be regulated in the relevant offshore jurisdiction. This advantage may be diminished in years to come following the full implementation of the Alternative Investment Fund Managers Directive (AIFMD) – which will ultimately require offshore managers to submit to equivalent regulation if they wish to market their funds in Europe.

Generally speaking, an ELP is a familiar and popular private equity fund vehicle. Some investors are prohibited from investing in, or are reluctant to invest in, structures established in Jersey or Guernsey, but will be more comfortable investing in an ELP because it is a European Economic Area (EEA) vehicle. US investors in particular are familiar with the partnership structure through the widespread use of DLPs and ELPs can easily accommodate standard US investor issues such as ERISA (Employee Retirement Income Security Act), UBTI (Unrelated Business Taxable Income) and bank holding company restrictions.

Furthermore, the UK government has recently made a number of amendments to the Limited Partnerships Act 1907 which have added to the attractiveness of ELPs as private equity fund vehicles, in particular, by simplifying the registration process and thereby adding greater certainty as to when the limited partners of an ELP gain (and potentially lose) limited liability. There are a number of further proposals for reform which would also improve the attractiveness of ELPs and which have been consulted on recently. Unfortunately the timetable for their implementation is unclear. The key proposals include:

- the removal of the requirement that an ELP have a principal place of business in the UK in order to be registered;
- the introduction of a number of safe harbour activities in which a limited partner may participate without risking its limited liability (thus negating an advantage over ELPs which Delaware, Cayman Islands, Jersey and Guernsey limited partnerships currently enjoy); and
- the removal of the prohibition on limited partners withdrawing capital from the ELP. This would obviate the need for their commitments to be split between loan and capital components.

Scottish limited partnerships

Scottish limited partnerships (SLPs) are more commonly used as vehicles for private equity funds of funds and carried interest vehicles. This popularity stems from the fact that, like ELPs, SLPs are tax-transparent but, unlike ELPs, SLPs have separate legal personality.

The purpose of a fund of funds is to invest in private equity funds on behalf of the fund of funds' investors. Without the 'blocker' effect of a vehicle with separate legal personality, a fund of funds' investors would, for legal and registration purposes, be treated as direct investors in the private equity funds in which the fund of funds invests (portfolio funds). As such, any change in the identities or commitment amounts of the investors in the fund of funds would also constitute a change in the identities or commitment amounts of the investors in each of the portfolio funds. This would present a number of difficulties for the portfolio funds for two reasons.

Firstly, each time a new investor joined the fund of funds or an existing investor varied its commitment amount, each portfolio fund would be required to update its own register of investors accordingly and make any necessary regulatory filings. Secondly, if the relevant event occurred after a portfolio fund's final closing date, a technical breach of the terms of the portfolio fund may result, as it is usually not permitted for a portfolio fund to admit new investors after its final closing date except pursuant to a transfer from an existing investor. SLPs are popular vehicles for funds of funds as their separate legal personality means that these problems are avoided because it is the SLP itself, rather than its investors, which is the registered investor in its portfolio funds.

For the same reasons, SLPs are also popular vehicles for carried interest schemes.

Cayman exempted limited partnerships

The Cayman Islands limited partnership law allows for limited partnerships along the English model: the limited partners have to be registered and gazetted; the role of limited partners is limited to that of 'silent partners'; changes in the partnership agreement have to be gazetted; and a limited partner's right to share in the profits is seemingly limited to taking interest at a fixed rate payable only out of profits. In addition, in 1991, the Cayman Islands passed the Exempted Limited Partnership Law (as revised, including by the Exempted Limited Partnership (Amendment) Law 2009), which established the

exempted limited partnership, which does not have any of these features and is more closely aligned with the Delaware model. Nevertheless it is noteworthy that a Cayman exempted limited partnership (CELP) is not a juridical entity but a set of contractual obligations.

A CELP has a number of innovative features, including:

- The governor can grant an undertaking that neither the partnership nor the limited partners will be subjected to any form of taxation for a period of 50 years from the date of the undertaking.
- It may be formed to undertake any lawful purpose provided it does not undertake business with the public in the Cayman Islands.
- It must maintain a registered office in the Cayman Islands and one of the GPs must have a 'local connection' (that is, must be resident in Cayman if an individual and registered in Cayman if a company or a partnership).
- The limited partnership agreement (LPA) may contain certain safe harbours which allow a limited partner to engage in some activities in relation to the management of the partnership without jeopardising their limited liability, including:
 - ◆being a contractor, agent or employee of the CELP;
 - ◆being a contractor, agent or employee of a GP;
 - ◆acting as a director, officer or shareholder of a corporate GP;
 - ◆consulting and advising a GP regarding the business of the partnership;
 - ◆investigating, reviewing, approving or being advised on the accounts or business affairs of the partnership;
 - ◆acting as surety or guarantor for the partnership in respect of general or specific obligations;
 - ◆approving or disproving certain amendments to the partnership agreement; and
 - ◆voting on:
 - the dissolution and winding up of the CELP;
 - the acquisition or transfer of any asset or assets by or of the CELP;
 - the incurrence or renewal of indebtedness by the CELP;
 - a change in the nature of the business of the CELP;
 - the admission, removal or withdrawal of the general or limited partnership and the continuation of business thereafter; and
 - transactions in which one or more of the GPs have an actual or potential conflict of interest with one of the limited partners.
- Subject to any express or implied provision in the partnership agreement to the contrary, a CELP is not dissolved by a change in

one or more of the limited partners; the assignment or creation of a charge over the whole or part of a limited partner's interest; or the death, withdrawal or insolvency of a limited partner.

- It is also provided that the death, withdrawal or insolvency of the GP would not automatically lead to dissolution of the partnership but allow the limited partners a period in which they could reconstitute the partnership.

- The right to assign or mortgage a partnership interest is expressly recognised by the law (a former prohibition on transfers without GP consent was removed by the 2009 reforms).

- The mechanism for registration only requires the signature of the GP and in certain cases a statement of good standing. Registers of limited partners and mortgages are maintained by the GP and are not required to be filed.

- Any property held by the GP for and on behalf of the CELP is deemed to be held on trust by the GP as an asset of the partnership.

- Its limited partners may only receive payments out of the capital of the partnership if at the time, and immediately following the distribution, the partnership is solvent. If within six months of receipt by the limited partners of a payment it is discovered that the partnership is insolvent, the distributed funds must be repaid to the partnership in addition to an interest penalty calculated at 10 percent per annum (calculated on a daily basis).

- The partnership must make an annual return and pay an annual return fee, but there is no statutory requirement that the accounts be audited.

German KG

German institutional investors tend to use the German *KG vehicle* (*Kommanditgesellschaft*), among others, for specific regulatory reasons. In particular, certain German institutional investors – insurance companies and pension funds – are restricted from investments in non-Organisation for Economic Co-operation and Development (OECD) partnerships. In order for such German investors to be permitted to invest, the terms of the partnership agreement of a (German or foreign) partnership must comply with specific regulatory and accounting requirements (some of which are set out in a recent circular of the German regulator dated April 2011), with which private equity funds that do not specifically target German investors usually do not comply. A German KG requires some German-based infrastructure including a German GP.

Neither the KG itself nor its German GP need to be authorised by the German regulator, although this may change once AIFMD has been implemented. If German individual investors are limited partners in the KG and the KG is trading in securities, a specific regulatory licence requirement as a financial services institution may apply.

There has been much debate as to the tax efficiency of management fee and carried interest structures used in connection with German KGs. According to German administrative practice, the management fee is subject to value added tax (VAT) if it is payable irrespective of whether or not the KG has generated a profit.

The German Income Tax Act provides for a tax-exemption of 40 percent of carried interest receipts if the fund qualifies as a non-commercial partnership. The criteria set out in the decree in respect of the differentiation between (mostly favourably taxed) non-commercial and commercial fund partnerships, which is also relevant to avoid trade tax at the level of a commercial fund partnership, have been clarified further through publication of an administrative pronouncement in the autumn of 2004. In addition to a detailed activity test, it needs to be ensured that at least one limited partner must be endowed with management authority under the KG's LPA or alternatively, the GP is neither a corporation nor a (deemed) commercial limited partnership.

Furthermore, a non-commercial partnership which is a direct partner in a commercial partnership will itself be 'tainted', that is, would also be treated as a commercial partnership. This tainting can be avoided by structuring investments in commercial partnerships through blocker GmbHs. In certain circumstances, however, the use of a commercial partnership may be preferable for some German corporate investors since they may benefit from a trade tax exemption.

Dutch CV

A Dutch limited partnership (*commanditaire vennootschap*, or CV) can be used to invest alongside an ELP or a Luxembourg FCP and, in certain cases, have been used as the primary fund structuring vehicle. They can be used to accommodate Dutch investors who sometimes require a separate parallel fund vehicle structured so as to avoid classification as a 'corporation' for Dutch tax purposes (which would lead to adverse tax consequences).

Particular characteristics required to ensure that the Dutch CV is tax-

transparent for Dutch tax purposes (for example, ensuring that transfers of limited partner interests only occur if the consent of all general and limited partners has been obtained) tend to make these vehicles more suitable as bespoke parallel entities for a particular set of Dutch investors rather than as the primary fund vehicle.

There is currently a proposal for new statutory law in the Netherlands that will cover certain types of Dutch partnership including CVs. It is uncertain when the new law will come into effect. One of the more far-reaching sections of the legislation will allow a CV to be a CVR (*commanditaire vennootschap met rechtspersoonlijkheid*): an entity with separate legal personality, that is, separate from the partners, similar to a corporate. This is something the current laws do not allow. No change in the tax regime applying to CVs or CVRs is contemplated.

French FCPR

The *fonds commun de placement à risques* (FCPR) is a co-ownership of securities without separate legal personality that is transparent for French tax purposes. It is set up by a French management company approved by the *Autorité des marchés financiers* (AMF) and by a custodian. Provided that the subscription and acquisition of units in the FCPR are restricted to 'qualified investors' (as defined by French law), an FCPR can benefit from a simplified procedure pursuant to which it does not itself need to be approved by the AMF (simplified FCPR).

A simplified FCPR must satisfy an investment quota (the 'legal quota') pursuant to which at least 50 percent of the assets of the FCPR must consist of:

- quasi-equity or equity securities of companies or securities giving access to equity of companies, which are not traded on a French or foreign financial instruments market operated by a market undertaking, an investment services provider or any other similar foreign entity; or
- shares of limited liability companies (*sociétés à responsabilité limitée*) or of companies of an equivalent status in their country of residence.

The assets of a simplified FCPR may also consist of:

- within a limit of 15 percent, shareholder loans granted, for the term of the investment made, to companies in which the simplified FCPR has a shareholding. These loans are taken into account in the calculation of the legal quota when they are granted to companies

satisfying the conditions to be included in the legal quota; and

- rights representing a financial investment, issued under French or foreign law, in an entity whose main purpose is to invest directly or indirectly in companies whose equity securities are not traded on a French or foreign financial instruments market operated by a market undertaking, an investment services provider or any other similar foreign entity. These rights are only included in the legal quota to the extent of the percentage of direct or indirect investment of such entity's assets in companies eligible for inclusion in the legal quota.

Equity securities, or securities giving access to equity, issued by companies with a market capitalisation below €150 million and traded on a market of a member state of the EEA, are also eligible for inclusion in the legal quota within a limit of 20 percent of the assets of the simplified FCPR. In addition, when the securities of a company which form part of the legal quota are admitted for trading on a French or foreign financial instruments market, they continue to be included in the legal quota for a period of five years following the date of their admission.

This five-year limitation period does not, however, apply if the shares of the company admitted to trading satisfy the conditions to be included within the legal quota on the date of quotation and if, taking into account these shares, the simplified FCPR satisfies the aforementioned 20 percent threshold.

French tax-resident unitholders may benefit from a favourable tax regime provided that the securities taken into account in the legal quota are issued by companies which:

- have their registered head office in a member state of the EU or in another member state of the EEA having entered into a double tax treaty with France that contains an administrative assistance clause to prevent tax fraud or evasion;
- perform a commercial or industrial activity; and
- are subject to French corporate income tax under ordinary conditions or would be subject thereto under the same conditions if their activity was performed in France (such simplified FCPR being referred to as a 'fiscal FCPR').

For French corporate investors subject to corporate income tax, this tax regime translates into a conditional exemption of capital gains distributed by the simplified FCPR (whether such gains are realised directly by the simplified FCPR itself or, where the simplified FCPR is a fund of funds, indirectly through another investment fund) and of

capital gains realised on the sale of their units in the simplified FCPR.

For French individual investors (other than carried interest unitholders), this tax regime translates into a conditional exemption (excluding social levies) of income and capital gains distributed by the simplified FCPR and of capital gains realised on the sale of their units in the simplified FCPR.

For a non-French tax-resident investor, whether or not the simplified FCPR is a fiscal FCPR, no tax is due in France on capital gains realised by the simplified FCPR on the sale of shares in a portfolio company which are distributed to the investor provided (subject to double tax treaties) that the rights held (indirectly) by the investor in the profits of the portfolio company did not exceed 25 percent of such profits at any time during the five preceding years. Distributions by the simplified FCPR of French source dividends are subject to French withholding tax at the rate of 25 percent and distributions by the simplified FCPR of French source interest are subject to French withholding tax at the rate of 18 percent (subject in both cases to double tax treaties).

Another undeniable advantage of the simplified FCPR is that carried interest distributed to members of the management team benefits, under certain conditions, from a favourable tax regime, that is, taxation at the overall rate of 30.1 percent (including social levies) as opposed to progressive income tax rates.

However, the French Finance Act for 2009 introduced new and important rules on the taxation of carried interest received from FCPRs, which essentially provide that distributions received from and gains realised on the disposal or redemption of carried interest units issued by an FCPR are liable to income tax.

This is pursuant to the rules applicable to salaried income unless a number of cumulative conditions are satisfied, in which case the capital gains tax regime may apply instead, that is, taxation at the overall rate of 30.1 percent (including social levies).

The conditions that carried interest units issued by an FCPR must satisfy to enable carry recipients to benefit from the capital gains tax regime are:

- They are subscribed or purchased in consideration for a subscription or purchase price corresponding to their value.
- They represent a single class of units.

- They represent at least 1 percent of the total amount of subscriptions to the FCPR or, by special dispensation, a lower percentage to be set by decree after consultation with the AMF.
- Amounts derived from carried interest units are paid out at least five years after the date of establishment of the FCPR.
- Carried interest is paid out after reimbursement of commitments drawn down from the other unitholders.

In addition, the holder of carried interest units must be an employee (or an officer liable to income tax under the rules applicable to salaried income) of the management company of the FCPR or of a company that provides services connected to the management of the FCPR. The holder must also receive a normal remuneration in respect of his/her employment contract or management duties.

These new provisions will apply to FCPRs established as from the earlier of: (a) the date of publication of the decree referred to above; and (b) June 30, 2009.

In recent years, tax and legal developments have improved the position of the simplified FCPR. Coupled with the rise in investments in France and the increasing profile of French private equity teams, this had led some funds with pan-European ambitions to choose the simplified FCPR as their central vehicle. The simplified FCPR, however, has demonstrated certain competitive drawbacks as compared to some other foreign investment vehicles.

This is why the *loi de modernisation de l'économie* (law number 2008-776 dated August 4, 2008) introduced a new form of investment fund, the *fonds communs de placement à risques contractuels* (contractual FCPR), as part of a broader initiative to increase the competitiveness and attractiveness of France as a host country for certain financial services, including asset management. The idea behind the contractual FCPR is to provide French asset managers with a more flexible investment vehicle better equipped to compete against foreign investment vehicles, in particular the ELP and Luxembourg SICAR.

The particular advantage of a contractual FCPR is that its by-laws determine its investment rules and, except with respect to the purchase of debt instruments (which is limited to 15 percent of the higher of its net asset value and the paid-up amount of commitments), the contractual FCPR does not need to comply with an investment quota. Although at this stage French tax-resident investors holding units in a contractual FCPR are not entitled to any favourable tax

regime, the aforementioned tax regime applicable to carried interest should extend to carried interest paid by a contractual FCPR.

Spanish FCRs

Spanish FCRs (*Fondos de Capital-Riesgo*) are separate pools of assets legally and beneficially owned by investors but managed by a management company.

The main characteristics of Spanish FCRs are an absence of legal personality, limited liability, ¹ no tax transparency and regulated status.²

The main purpose of Spanish FCRs is generally restricted to the acquisition of temporary equity stakes in companies which are not:

- financial entities (although there exists a specific regime for funds of funds);
- devoted to real estate (although property-intensive businesses such as hotels, hospitals or infrastructures may qualify as eligible investments); or
- listed on the primary stock exchange of an EU or OECD country (although exemptions are provided for public-to-private deals and liquidity through flotation of portfolio companies).

There are two types of Spanish FCRs:

- ‘general regime’ FCRs, which target a wide number of investors and are subject to more stringent supervision; and
- ‘simplified regime’ FCRs, closed-end structures aimed at private placement within institutional investors and subject to less regulatory burden.
- Simplified regime FCRs are preferred for private equity fund structuring as they allow tax-efficient carried interest schemes (through ‘profit shares’ allotted to founders and sponsors).

Although formally FCRs are corporate income taxpayers, they enjoy a 99 percent exemption on capital gains derived from the realisation of investments and a 100 percent exemption on dividend income. Interest payments are, however, taxable at a 30 percent rate in the hands of FCRs and this has emerged as one of the more significant drawbacks when it comes to optimising acquisition structures (mainly because equity funding of acquisition vehicles normally triggers 1 percent capital duty and does not generate deductible payments for the target group).

FCRs are likewise attractive for Spanish corporate investors, which will not be subject to taxation on the dividends and capital gains derived from their investments in an FCR. Similar rules apply to foreign investors that do not have a permanent establishment in Spain, provided that the income is not obtained through a tax haven territory for Spanish purposes. (This can of course be problematic for many investors based in or investing through many popular offshore jurisdictions.) In addition, management fees charged by management companies are generally exempt from VAT.

Finally, it is worth mentioning that Spanish law also provides for SCRs (*Sociedades de Capital-Riesgo*) which share many of the features of an FCR but are body corporates with legal personality and may be self-managed, that is, by the SCR's own board of directors. SCRs are suitable for certain classes of investors such as Spanish family offices, which need to invest in 'shares' issued by corporations to qualify for certain tax exemptions.

Dutch FGR

An alternative way of structuring a fund or parallel or feeder vehicle under Netherlands law is by setting up a Dutch FGR (*fonds voor gemene rekening*), a Dutch mutual fund. This is essentially a set of agreements between, on the one hand, the investors (each entering into a participation agreement) and, on the other hand, the depository and the fund manager. The assets in a Dutch FGR structure are legally held by a separate entity, the depository. Typically the depository is set up as a bankruptcy remote vehicle, as a result of which the position as regards asset ownership is materially equal to the Luxembourg FCP.

A participant in the FGR holds a contractual claim on the depository in respect of the assets similar to, for example, holding a commercial bank account. This contractual relationship is also reflected in the underlying document constituting the FGR, to which the participant, the depository and also the manager will adhere ('terms and conditions of management and custody'). In accordance with these terms and conditions both the depository and the manager will act for the benefit of the participants in the FGR.

Dutch fund managers (irrespective of their legal form or the legal form of the fund managed by them, that is, CVs, BVs, NVs or FGRs) will need to be authorised in the Netherlands by the Netherlands Authority for the Financial Markets (*Autoriteit Financiële Markten*, or AFM) if the fund is marketed in the Netherlands, unless a private placement

exemption is available. Examples of such exemptions are a minimum investment threshold of €50,000 (to be increased to €100,000 on January 1, 2012) and on an offering to qualified investors only.

The specific advantages of an FGR include the following:

- Compared to the Dutch CV, the relevant restrictions on the transfer of participations in a Dutch FGR are more flexible, and consequently a Dutch FGR can be established as an open-ended mutual fund.
- The FGR has been successfully tested as a tax-transparent vehicle in international structures for decades. Moreover, the Dutch authorities are also actively consulting the authorities of relevant tax treaty partners to arrange for the official acknowledgement of the FGR as a tax-transparent vehicle for non-Dutch tax purposes (bilateral agreements with the UK and Canada are in place).
- Dutch civil law and absence of supervision (if elected) allow for flexible FGR terms and conditions. This means that specific features could be quite easily introduced and be tailored.
- There is no requirement for the Dutch FGR to engage local third-party service providers in the Netherlands, including a manager and custodian. This greatly enhances the efficiency of an FGR fund structure.

In addition, it should be noted that the FGR can also be set up as a non-transparent vehicle subject to Dutch corporate tax (the open FGR). The open FGR can, among other things, apply for the so-called Dutch exempt investment institution regime (*vrijgestelde beleggingsinstelling*, hereinafter VBI). The VBI regime for the open FGR will be further discussed in the section entitled 'Corporate tax-exempt fund vehicles'.

Luxembourg FCP

The Luxembourg FCP (*fond commun de placements*) is a widely used and popular pan-European fund vehicle, especially for real estate investment structures. The investor may opt between different Luxembourg private equity regulatory regimes: the Part II UCIs (undertakings for collective investment) – subject to Part II of the Law of December 20, 2002 on undertakings for collective investment, as amended; or Part II of the Law of December 17, 2010 on undertakings for collective investment – and the SIFs (*fonds d'investissement spécialisé* or specialised investment funds) – subject to the Law of February 13, 2007 on specialised investment funds, as amended. Each regime has its specific requirements.

The private equity FCP can therefore qualify as either a Part II UCI or an SIF.

The FCP is not a distinct corporate entity, but a co-ownership of assets. The FCP does not have any legal existence and is represented by its management company (*société de gestion*). The FCP is established by contract, that is, the management regulations established by the management company of the FCP. The provisions of the management regulations are deemed to be accepted by the unitholders on the basis of the mere fact that they have acquired the relevant units. The activities of the management company are limited to fund the management of one or more FCP(s).

Specific advantages include the following situations:

- A listing on the Luxembourg exchange is possible as there should be no restrictions on the types of investors who can participate, except that only well-informed investors³ may invest in a SIF.
- It is generally regarded as tax-transparent and free of any corporation tax on any profits and additionally should, generally speaking, be able to avoid the requirements to withhold tax on distributed profits which apply to taxable corporate.
- The promoter can exercise entire control through holding shares of the management company, which acts for the account and on behalf of the FCP.
- It is possible to agree to corporate governance systems and controls.
- Services deemed to relate to the 'management' of the FCP are exempt from Luxembourg VAT. In this respect, the European Court of Justice (ECJ) stated in the Abbey National case (C-16/9/04) that in addition to the task of portfolio management, those of administering the funds themselves (notably the administering tasks listed in Annex II to *Directive 85/611/EEC* under the heading 'Administration'), which are functions specific to the funds, come within the scope of the term 'management'. The depository functions, however, are not considered to be covered.

Specific disadvantages include the following:

- Both the FCP itself and the management company need to be authorised by the Luxembourg financial regulator (the *Commission de Surveillance du Secteur Financier*, or CSSF) and the appointment of an asset manager in relation to a Luxembourg-based Part II UCI requires the approval of the CSSF.
- The management company of the FCP must be Luxembourg based

and the FCP's central administration (that is, head office) must be carried out from Luxembourg. However, this may not be a disadvantage to a large management group that already has infrastructure in Luxembourg. These services may also be delegated to Luxembourg-based service providers.

- The FCP is subject to a number of investment restrictions and limitations on external leverage which may fetter the manager's discretion (although some of these restrictions may be capable of waiver or regulatory derogation depending on the exact type of vehicle used, for instance, in the case of a SIF).

- There are certain entity level taxes for the management company of an FCP, namely:

- (i)capital duty (*droit d'apport*), a one-time fixed fee of €75 due upon incorporation; and

- (ii)annual subscription tax (*taxe d'abonnement*), a tax payable on the total net assets of the fund, generally at the annual rate of 0.05 percent per annum for Part II UCIs (a reduction to 0.01 percent per annum is applicable in certain cases, for example, institutional money market funds) or 0.01 percent per annum for SIFs.

Total exemption is possible under certain circumstances, for example, microfinance funds and exchange-traded funds.

- From a German tax perspective, the tax treatment of a private equity FCP is uncertain.

- Some industry approaches to certain issues such as the use of carried interest to align manager and investor interests and with which investors are familiar in a partnership context may be less straightforward to replicate in FCP format.

The corporate taxable fund vehicle

The principal types of corporate taxable fund vehicles are the Luxembourg SA or SCA; the Dutch BV, NV or Cooperative; and the German GmbH.

Advantages

The principal advantages of these structures are:

- These vehicles are generally unregulated (as with some but not all of the partnership fund vehicles).

- From a tax perspective such a vehicle will have access to a wide double tax treaty regime without the need to interpose a further sub-

fund layer as would be the case with a limited partnership.

- These vehicles will be able to take advantage of the EU Parent/Subsidiary Directive, which exempts dividends from withholding tax and corporate tax (although there is likely to be dividend withholding tax at the level of the vehicle when dividends are distributed where investors themselves cannot take advantage of the Directive).
- The 'participation exemption' system, which provides for exemptions from dividend income and capital gains, is applicable to a number of these vehicles (for example, in Luxembourg, Germany and the Netherlands).

US taxable investors generally will prefer a fund that is treated as a partnership for US tax purposes. A fund organised as a Luxembourg SCA or SARL, a Dutch BV or a German GmbH may elect to be treated as a partnership for US tax purposes. However, partnership treatment is unavailable for a fund organised as a Luxembourg SA, a Dutch NV or a German AG.

Disadvantages

The principal drawback meanwhile is that interest income distributed or received by the fund is fully taxable and therefore it is important that part of the funding for the vehicle is provided by way of debt, the interest expense of which can be offset against fund income (subject to any thin capitalisation and other restrictions on tax deductibility of interest expenses). It is also possible that from a corporate governance perspective, certain shareholder rights prescribed by local law would go beyond the level with which the manager would be comfortable for a passive investment fund.

Luxembourg vehicles tend not to be as familiar to US investors as, say, an ELP which in itself may be a disadvantage.

Luxembourg taxable corporates

There are a number of types of Luxembourg 'corporate' vehicles which may be used as fund vehicles (and each of which can qualify as a '*Soparfi*'), including:

- the SA (*Société anonyme*) or joint stock company or public limited company;
- the SARL (*Société à responsabilité limitée*) or private limited company; and
- the SCA (*Société en commandite par actions*), which is the closest

Luxembourg corporate equivalent to the ELP.

Taking each of these in turn, the basic features of each of these vehicles are outlined below.

SA

The SA is run by its own board of directors rather than by a separate management company, although many management powers could be delegated to an investment manager. It therefore has a closer resemblance in terms of structure to an offshore corporate fund than to a limited partnership.

SARL

The SARL is similar to the SA, but is not generally used as a fund vehicle, not least because, under its constitution, transfers of units in the company cannot be made to non-members without three-quarters approval of the members generally. However it may be suitable as a joint venture, management or administrative vehicle in relation to a fund.

SCA

The SCA is the closest Luxembourg corporate equivalent to an ELP. It has two types of shareholders, namely those with limited liability and those with unlimited liability. As with the ELP, those with limited liability are not allowed to participate in management of the SCA (or they risk losing their limited liability) which must in turn be conducted by the unlimited partners.

These vehicles can each qualify as a *Soparfi*. This classification refers to fully taxable corporate bodies which benefit from the EU Parent/Subsidiary Directive. As a result, the *Soparfi* will be exempt from tax on dividend income and liquidation proceeds derived from qualifying subsidiaries, provided certain conditions are met. By extension, capital gains tax will also be exempt under similar conditions. Any other income (such as interest income) would, however, remain fully taxable at the rate of 28.8 percent for companies established in Luxembourg City (unless this income is offset by interest or other expenses).

Dividends paid by a *Soparfi* can benefit from a withholding tax exemption under certain conditions. Liquidation proceeds do not suffer any withholding tax and the repatriation of profits can be organised in a tax-efficient way through the use of convertible/hybrid debt instruments (an advance tax agreement should be obtained in this respect).

A potential disadvantage of some of the Luxembourg structures is that

they require a meaningful presence in Luxembourg. While there are no specific Luxembourg requirements or constraints on how the concept of 'meaningful presence' might be interpreted, some managers have become more concerned with this issue and increased the substance of their Luxembourg operations in order to guard against the tax authorities of the country of the state of residence of the manager/promoter and/or the tax authorities of the target investment country challenging the Luxembourg residence of the fund.

Neither these vehicles nor (generally) their managers will need to be authorised by the Luxembourg regulator. However, if the manager of a SARL or of an SCA were located in London, for example, there would be a risk that the Luxembourg fiscal residency of the Luxembourg fund vehicle might be challenged by foreign tax authorities, unless the manager has a meaningful presence in Luxembourg. In addition, where the fund has an 'asset manager' (whose role is limited to the financial management of the assets, rather than the corporate governance of the fund) there is no requirement that the manager be regulated and have a presence in Luxembourg, as long as fund assets are not located in Luxembourg. If there were assets located in Luxembourg, the manager would need to be regulated in its home state (possibly by way of an EU passport) to conduct this activity in Luxembourg, but it should not necessarily have a presence in Luxembourg. If the activities of these entities qualify them as a UCI they will be governed by the relevant Luxembourg UCI law and be subject to the suspension of the Luxembourg regulator.

Luxembourg SICAR

The amended Luxembourg law of June 15, 2004 on investment companies in risk capital (SICAR or *société d'investissement en capital à risque*) establishes a private equity fund regime for ordinary commercial entities (SICAR law). The SICAR regime supplements rather than replaces the other existing Luxembourg fund products.

The object of a SICAR is to invest its assets in 'securities representing risk capital in order to provide to the investors the benefit of the result of the management of the SICAR's assets in return of the risk they bear'. Investment in risk capital is defined by the SICAR Law as 'the direct or indirect contributions of assets to entities with a view to their launching, development or listing on a stock exchange'. In light of this definition, risk capital shall, generally speaking, be characterised by the concurrent gathering of two elements, namely (i) a high risk and (ii) an intention to develop target entities.

This definition is not exhaustive, but given as an example. Indeed, no kind of investment is expressly excluded from the concept of risk capital, and any investment which qualifies as risk capital is *prima facie* eligible to the extent that the investors incur a risk, in full knowledge of the facts, in order to be provided with the benefits of the result of the management of the SICAR's assets in return of the risk they bear.

In practice, several aspects are considered (for instance, number and type of target entities, their maturity level, development projects and planned holding duration) to determine whether a SICAR's investment policy complies with the intention to develop target entities as required by the SICAR law.

SICARs may take the form of an SA, a SARL, an SCA, an SCS (*sociétés en commandite simple*) or an SCOSA (*société coopérative organisée sous forme de société anonyme*).

The principal benefits are:

- SICARs are not subject to risk diversification with regard to investment (that is, the SICAR may hold one or more securities of the same issuer) or borrowing limits. However, the CSSF considers that a SICAR may use derivative instruments for hedging purposes only or where such transactions are necessary to the realisation of its investment policy (investment in derivative instruments cannot constitute the object of its policy).
- Services deemed to relate to the 'management' of a SICAR are exempt from Luxembourg VAT (see the Luxembourg FCP section above concerning the ECJ's interpretation of the term 'management').
- SICARs are not subject to taxation on income deriving from securities (dividends/capital gains on shares, interest on bonds).
- No withholding tax applies on dividends paid by a SICAR.

The principal disadvantages are:

- Although SICARs benefit from a fast-track authorisation procedure, the vehicles nonetheless still need to be authorised by the CSSF.
- Luxembourg infrastructure (for example, a CSSF-approved custodian or central administration in Luxembourg) is required. This may not be a disadvantage to a large management group which already has infrastructure in Luxembourg.
- It can only be sold to institutional, professional and well-informed investors. They are those who declare in writing that they satisfy the experienced investor criteria and invest a minimum of €125,000 or

obtained an assessment from a credit institution, another professional of the financial sector or a management company, certifying their expertise, experience and knowledge to understand and evaluate in an appropriate manner an investment in risk capital.

- In March 2006, the EU Commission raised a series of questions to the Luxembourg government that could potentially incur an official investigation of this regime in the light of illegal state aid provisions. There has been no official investigation as of the date of publication.

Dutch taxable entities

The BV and NV corporate entities are common vehicles (having separate legal personality) in the Netherlands for the purposes of fund structuring. In addition to these corporate entities, the private equity market has seen the arrival of the popular Dutch cooperative.

BV

In the BV (*besloten vennootschap met beperkte aansprakelijkheid*) entity, the capital is divided into shares. Each shareholder is obliged to pay up the par (nominal) value of the shares and any agreed premium, effectively representing the balance of its commitment to the fund. In principle, a shareholder will have no further liabilities other than in special situations where the corporate veil may be pierced or when other obligations have been agreed. The shares may be ordinary, or have special features such as rights of 'control' (priority shares), rights of financial (preference shares) or rights of tracking stock. A BV's articles of association are legally required to contain a 'blocking clause' so that transfers of shares must be restricted, that is, subject to approval of some organ of the company (for example, the management board or the general meeting of shareholders) or subject to first rights of refusal in favour of the other shareholders.

The BV entity is not suitable for listing on a stock exchange. In the near future, Dutch BV legislation will be amended for the sole purpose of offering further flexibility to BV users.

NV

The same principles relating to shares and shareholders noted above in respect of BVs apply equally to NVs (*naamloze vennootschap*). However, there is no 'blocking clause' requirement, and therefore this entity is suitable for trading on an exchange.

For Dutch tax purposes there is no difference between a fund established as a BV or as an NV. The Dutch participation exemption

(see below) would in principle apply to investments of at least 5 percent (or more) in an underlying private equity investment company.

Cooperative

The Dutch cooperative (*coöperatie*) is a tested holding, joint venture, fund and structured finance vehicle. Due to its favourable tax treatment, the private equity market has recently seen a steady growth in the popularity of the Dutch cooperative.

The Dutch cooperative is a legal entity with corporate, institutional or individual members, established for the purpose of providing for the economic needs of its members by means of carrying out business on their behalf. This business may be a private equity or private equity-related business. The applicable legislation offers extensive flexibility in respect of the governance, funding/financing and distribution provisions of the cooperative.

Additionally, a cooperative may elect full, partial or no liability of its members for debts of the cooperative. Cooperatives have the following tax benefits:

- A cooperative is a separate taxpayer which is subject to Dutch corporate income tax (similar to the Dutch BV or NV). Like the BV and NV, the cooperative can benefit from the Dutch participation exemption, which exempts the cooperative from tax on dividends and capital gains from qualifying participations of the cooperative (that is, in principle a 5 percent threshold in an underlying private equity investment company, as aforementioned).
- Dutch entities that are members of a cooperative can, regardless of the size of their interest in the cooperative, also benefit from the Dutch participation exemption and accordingly, dividends and other proceeds they receive from the cooperative are exempt from corporate income tax.
- If structured properly, the cooperative is not subject to Dutch dividend withholding tax (*dividendbelasting*). As a consequence, no Dutch dividend withholding tax will be withheld from distributions by the cooperative to its members.
- Cooperatives, as well as BVs and NVs, are entitled to the benefits of the EU Parent/Subsidiary Directive and the EU Merger Directive.
- The Netherlands has an extensive double tax treaty network, in principle preventing any Dutch taxation on the capital gains of non-Dutch corporate investors in respect of their substantial interests in a Dutch cooperative, BV or NV. However, should the corporate investors not be resident in a relevant Dutch tax treaty jurisdiction, proper tax structuring could still prevent any Dutch taxation claim on

capital gains derived from a substantial interest in a Dutch cooperative.

It should, however, be noted that the above tax considerations reflect some basic rules as promulgated in the law. In practice, the tax authorities tend to impose certain additional requirements in respect of applications for advance tax rulings.

German GmbH

The German GmbH is a limited liability company. Its major advantages are: (i) provided certain conditions are satisfied, only 5 percent of dividends and capital gains from shares are taxable; (ii) there is scope for tailoring the articles of association to the needs of the fund; and (iii) relative ease of operation.

This vehicle does not need to be authorised by the German regulator in order to make private equity investments.

Corporate tax-exempt fund vehicles

The third main type of fund vehicle is the corporate tax-exempt vehicle. The main example is the Luxembourg SICAV or SICAF, a mutual fund or unit trust, or a Dutch VBI with the legal form of a Dutch 'open' mutual fund (open FGR) or NV.

Luxembourg SICAV and SICAF

In Luxembourg, a private equity fund may also be established as a Part II UCI or as an SIF incorporated in the form of an investment company with variable capital (*société d'investissement à capital variable*, or SICAV).

A SICAV Part II UCI may only be incorporated as an SA. A SICAV SIF may be incorporated as an SA, an SCA, an SARL or an SCOSA.

The SICAV requires approval from the CSSF. Luxembourg SICAVs share many of the specific advantages and disadvantages of Luxembourg FCPs (including the same regulatory analysis).

Specific additional advantages as compared to an FCP include:

- A corporate structure is more easily understood and accepted by certain investors than the contractually based form of the FCP.

- Cornerstone investors may be represented on the board of directors of the SICAV, provided that the promoter/initiator is represented by a majority of board members.
- Specific additional disadvantages as compared to an FCP are:
- All investors become shareholders of the SICAV and, as such, have the right to vote at any general meeting (which implies, *inter alia*, that the board members of the SICAV may be revoked by a simple majority vote of the shares present or represented at a general meeting).
- A general shareholders' meeting must be convened every year; this meeting must take place in Luxembourg.
- The shares of a SICAV must be fully paid-up at the date of issue, except for a SIF, the shares of which must only be paid-up to 5 percent.

A private equity Part II UCI or SIF may also be established as an investment company with fixed capital (*société d'investissement à capital fixe*, or SICAF) which may adopt various corporate forms. The SICAF generally has the same advantages as the SICAV. A disadvantage of the SICAF is that a capital increase or decrease requires a change of the articles of incorporation by decision of an extraordinary general meeting of shareholders with specific quorum and majority requirements.

Dutch VBI

Since 2007, it has been possible under Dutch law to establish a fund as an entity under the Exempt Investment Institution regime (*vrijgestelde beleggingsinstelling*, or VBI). Such Dutch VBI may have the legal form of a Dutch 'open' mutual fund (open FGR) or NV or any similar EU entity or similar entity from a Dutch tax treaty jurisdiction.

The VBI is a Dutch tax vehicle, similar to the Luxembourg SICAV.

The Dutch VBI is not subject to (and fully exempt from) Dutch corporate tax and its dividend distributions are not subject to Dutch dividend withholding tax. Moreover, income and capital gains derived by corporate investors from a substantial interest in a VBI are not subject to Dutch corporate tax.

Additional advantages of a Dutch VBI are:

- A VBI can be established as a Dutch 'open' mutual fund (open FGR), that is, a contractual entity without legal personality. The legal framework of an open FGR offers maximum flexibility as

participations in such a vehicle are not subject to any transfer restrictions (see paragraph above on limited partnerships and the discussion on the Dutch FGR).

- A Dutch VBI established as a Dutch open FGR offers maximum flexibility in respect of legal framework.
- There is no requirement for a Dutch VBI to engage local third-party service providers in the Netherlands, such as a manager or custodian.

Furthermore, the advantages mentioned above in respect of the Dutch FGR also apply to the Dutch VBI established as an open FGR.

Dutch VBIs are, however, subject to the following restrictions:

- The activities of the VBI should not go beyond normal portfolio management. In a private equity context in practice only a fund of funds may comply with this requirement. The Dutch VBI is required to invest in 'financial instruments' as defined in the Dutch Financial Supervision Act (*Wet op het financieel toezicht*, or *Wft*), for example, securities, futures and derivatives. Participations in share companies would typically meet this test.
- A Dutch VBI is required to have a risk spreading investment objective. This is marginally tested only, looking through to underlying investments.
- Since Dutch VBIs are tax-exempt, a VBI is not entitled to Dutch tax treaties benefits or the benefits of the EU Parent/Subsidiary Directive and the EU Merger Directive.

The Dutch VBI regime can be applied for through the filing of a relevant request with the Dutch tax authorities. In this respect it should be noted that the above tax considerations reflect some basic rules as laid down in the law. In practice, the tax authorities tend to impose certain additional requirements.

Specific investor issues

A detailed discussion of different investor types and their effects on fund structuring is beyond the scope of this article, although it is critical in the fund-structuring process. Investor groups with particular requirements will require specific structuring to accommodate them within fund structures. A number of specific examples are set out below.

Dutch resident investors

Historically, certain Dutch resident investors committing to a non-Dutch entity may want to ensure that the foreign fund to which they commit is treated as 'closed', that is, tax-transparent for Dutch tax purposes. This will generally be achievable provided certain criteria are met. From the point of view of a standard pan-European fund structure such as an ELP, the most important of these criteria is that interests in the fund can only be transferred and new partners admitted with the consent of all limited partners. This may necessitate creating a bespoke partnership solely for these Dutch investors (given that the transfer and admission points will generally not be acceptable to other investors).

German insurance companies and pension funds

German insurance companies and pension funds subject to the German Insurance Supervisory Act (*Versicherungsaufsichtsgesetz*, or VAG) are generally prohibited from investing directly in fund vehicles that are resident to non-OECD countries, which might require the establishment of a parallel or (German KG) feeder fund vehicle for these investors. German insurance companies and pension funds must, *inter alia*, be granted the explicit and unrestricted entitlement to freely dispose of their interests in private equity funds at any time. The German regulator requires particular wording to this effect to be included in the fund partnership agreements or in a side letter. Specific provisions may also be required with regard to leverage restrictions at the fund level and the provision of audited annual reports (as set out in a circular issued by the German regulator in April 2011). In 2010 the former restriction that German insurance companies may not hold more than 10 percent of the total commitments to the fund has been abolished.

If more than one German tax-resident investor is a limited partner in a foreign private equity fund structured as a partnership, the partnership has to prepare and file a partnership tax return in accordance with German tax rules. Furthermore, if German insurance companies or pension funds are directly invested as a limited partner in the foreign partnership, specific accounting requirements may apply.

German institutional and individual investors

German institutional and individual investors face the risk that an investment in a non-German fund vehicle may trigger adverse tax consequences in accordance with the German Investment Tax Act

(*Investmentsteuergesetz*, or GITA). As a consequence, a penalty tax charge could apply if extensive notification and publication requirements set out in the GITA are not complied with by the fund. The German regulator (*Bundesanstalt für Finanzdienstleistungsaufsicht*, or BaFin) has, however, in a circular dated December 22, 2008 confirmed a safe harbour exemption for certain non-German private equity funds.

In accordance with past market practice the safe harbour rule applies to foreign private equity funds which hold a substantial amount of their total investments in private equity investments with a view to exerting a controlling influence on the business activities of the target companies and thereby increasing the fair market value of such investments (that is, acting as an 'activist shareholder'). A more complex analysis applies in particular to private equity funds of funds and real estate private equity funds. If the GITA does not apply, German investors may be subject to the German controlled-foreign-company rules (CFC-rules) which may apply even if German investors hold less than 1 percent in the fund. Furthermore, in certain circumstances repayment of capital by fund vehicles or holding companies may be recharacterised as (taxable) income unless specific reporting requirements are satisfied. Due to the potential tax risks German investors may be exposed to with regard to investments in non-German private equity funds, an alternative structure has emerged in the form of 'fund-linked notes'. In this alternative structure, German investors acquire a note issued by a bank or a special purpose vehicle, the payout profile of the note mirrors the cash distributions which a direct investor in the underlying private equity fund would have received.

US taxable investors

US taxable investors normally will require the fund to be treated as a partnership for US tax purposes in order for such investors to obtain a flow-through of foreign tax credits and capital gains (which can be offset with capital losses and which may be taxed at reduced rates in the hands of US individual investors). This also enables the fund to avoid complex and potentially burdensome US regimes that may apply if it were organised as a non-US corporation. A DLP will be classified as a partnership for US tax purposes without the need for any election to be made with the IRS.

It is generally advisable, however, for a fund organised as a non-US partnership to file an election with the Internal Revenue Service (IRS)

to be treated as a partnership for US tax purposes, and a fund organised as a non-US limited liability company must file such an election to be treated as a partnership. Partnership treatment is unavailable for certain company forms in various countries including the *société anonyme* (SA), *aktiengesellschaft* (AG), *naamloze vennootschap* (NV) and public limited company (plc) forms. Accordingly, US taxable investors normally would be reluctant to invest in funds organised under such forms except for publicly traded funds (which in any event would raise specific US tax issues).

US tax-exempt investors

US tax-exempt investors do not have the same interest that the fund be treated as a partnership for US tax purposes. In fact, US tax-exempt investors generally will prefer that the fund be organised as a non-US corporation so there will be no flow-through of 'unrelated business taxable income' (UBTI), on which the US tax-exempt investors are subject to US taxation. Where a fund is treated as a partnership, a non-US corporate vehicle frequently will be established for US tax-exempt investors, thereby converting the UBTI into a dividend (by definition not UBTI) before it reaches the US tax-exempt investors. Where no such vehicle is used, US tax-exempt investors will frequently request an undertaking from the fund sponsor to structure investments to avoid generating UBTI.

The specific rules under which income and gains from investments will constitute UBTI are beyond the scope of this article; however, it should be noted that many common real estate investment strategies may generate UBTI, including property development projects, hotels, activities generating advisory, brokerage or other fee income, and investments financed with indebtedness (subject to certain exceptions).

US ERISA investors

Special considerations apply if a fund will receive investments by US employee benefit plans subject to the US Employee Retirement Income Security Act of 1974 (ERISA) or other employee benefit plans that are not subject to ERISA (typically US public pension plans), which request to be treated as if they are subject to ERISA. In particular, investment funds that accept investment from US employee benefit plans that are subject to Title I of ERISA (or Section 4975 of the US tax code) must comply with specific guidelines to avoid the

investment fund itself becoming subject to regulation under ERISA on the grounds that it manages 'plan assets' of its ERISA investors. The potential for regulation under ERISA will apply regardless of the fund's form or place of organisation, for instance, Delaware LP, ELP or FCP, or operation.

There are generally two paths an investment fund receiving investments from US pension plans can use to avoid becoming subject to regulation under ERISA. First, the fund will not be subject to ERISA if participation by employee benefit plans subject to Title I of ERISA or Section 4975 of the US tax code will not be deemed to be 'significant' (that is, less than 25 percent of each class of equity interests in the fund is owned by such 'benefit plan investors'). In general, the term benefit plan investor includes any US employee benefit plan that is subject to Title I of ERISA or Section 4975 of the code or any entity whose assets include the assets of any such employee benefit plan for these purposes. Second, the fund can structure its investments to qualify as a 'venture capital operating company' (VCOC) which enjoys a specific exemption from regulation under ERISA.

To benefit from the VCOC exemption, the fund must satisfy specific requirements regarding the nature and the structure of its investments in portfolio companies, and the management rights that it has and exercises over portfolio companies. Both alternatives have nuances and complexities that are beyond the scope of this article and we note that satisfying the rules can present specific structuring concerns.

Conclusion

This paper represents a general summary of the more common private equity fund vehicles seen in the European market. Although various regimes have sought to attract a share of the increasing appetite for private equity in recent years, experience suggests that familiarity and certainty tend to be formidable obstacles for anyone seeking to challenge the dominant vehicles and jurisdictions. It seems unlikely that this will be fundamentally changed by the AIFMD.

This new Directive will certainly have a major impact upon managers themselves and the manner in which they operate their funds; indeed the impact may be sufficient to restrict the size of the market and make some smaller funds unviable. However, where fund structures continue to be used it is likely that the vehicles described in this paper will continue to dominate the private equity fund market for the foreseeable future.

¹ Investors' liability is limited to the amount of their respective contributions to the FCR. In the same regard, the assets of the FCR are not exposed to claims made against investors or the management company.

² Spanish FCRs must be registered with and are subject to the supervision of the Spanish Securities and Exchange Commission (*Comisión Nacional del Mercado de Valores*). Furthermore, their financial statements must be audited on an annual basis. Management companies are also regulated.

³ A well-informed investor is an institutional investor, a professional investor or any other investor who meets the following conditions:

a) they have confirmed in writing that he adheres to the status of well-informed investor; and

b)(i) they invest a minimum of €125,000 in the SIF; or

(ii) they have been the subject of an assessment made by a credit institution within the meaning of Directive 2006/48/EC, by an investment firm within the meaning of Directive 2004/39/EC or by a management company within the meaning of Directive 2001/107/EC certifying his expertise, experience and knowledge in adequately appraising an investment in the SIF.

Appendix II

Sample drawdown notice



~~TO:~~ Committed Investor

14 - 17 Office Place

London

W1X 8JA

United Kingdom

~~FROM:~~ Definitive Equity Partners

~~DATE:~~ February 2011

Definitive Equity Partners: Investment Partners 1, L.P. (the "Fund") – Drawdown Notice 20

1. We refer to the amended and restated limited partnership agreement constituting the Fund (the "Partnership Agreement") and to your capital commitment to the Fund of €100,000.00. Capitalised terms defined in the Partnership Agreement shall have the same meaning in this letter except where the context otherwise requires.

2. This is a Drawdown Notice as referred to in clause 4.4.2 of the Partnership Agreement.

3. We hereby give you notice, pursuant to clause 5.6 of the Partnership Agreement, that you are required to advance a contribution equal to €9,999.99 by no later than 13 May 2011. The Drawdown advanced pursuant to this Drawdown Notice should be sent by telegraphic transfer to the following account:

4. Reliable Bank N.V.

Account Name: Definitive Equity Partners

Currency ISO Code: EUR

Amount: €9,999.99

SWIFT: ANBBGJ2L

IBAN: GB120 ANBB 1234 5678 910 11

Please ensure that all bank transfer charges are borne by the remitter so that the total contribution amount is received by the Fund.

5. It is intended that this drawdown will be applied by the fund in the manner set out in the attached schedule.

6. To acknowledge receipt of this notice please sign and return the fax reply sheet on the final page of this report to Bob Smith (Competent Fund Administration LLP) on +44 20 1234 5678, or by email to bs@CFALLP.co.uk, by 7 May 2011.

Yours sincerely,

~~Bob Smith~~

~~Director of Fund Administration LLP~~

Schedule to Drawdown Notice 20

Ms Committed Investor

All amounts in EUR

Total Commitment:	100,000.00
Contributions (prior to this Drawdown):	73,637.72
Percentage called (prior to this Drawdown):	73.64%
Remaining Commitment (prior to this Drawdown):	26,362.28

Amounts to be contributed at this Drawdown:

Drawdown 20: Drawdown for investment (Project Lobster)	6,807.21
Total for Drawdown Notice 20:	6,807.21

Remaining commitment (after drawdown):	19,555.07
Remaining commitment (as a % of total commitments):	19.56%

* Related to a 20% acquisition of of Dealer, a leader in the development and management of pan-european logistics.

Fax confirmation for receipt of drawdown notice



Fax reply for Drawdown Notice

Please sign and return this notice via facsimile to +44 1234 7890 by May 7, 2011.

If you have any questions regarding this transmission, please direct them to Roberta Smith on +44 207 397 5461 or email rsmith@CFALLP.co.uk

I confirm that I have received the Drawdown Notice for Definitive Equity Partners – Investment Partners 1, L.P. dated 29 February, 2011.

Investor:

Printed name:

Signature:

Date:

Appendix III



Sample distribution and drawdown notices



~~TO:~~ Jenny Taylor

2012 Tyrone Road

Phoenix

2011 Arizona

USA

~~FROM:~~ New Capital Fund Limited Partnership Limited

~~DATE:~~ December 13, 2010

~~RE:~~ Distribution

(Distribution Notice 4 & Drawdown Notice 9) for New Capital Fund LP

New Capital Fund Limited Partnership received its fourth Distribution in November 2010 when \$2,761,153 was Distributed by XYZ Company. This represents 3.2% of your Investment. In addition, New Capital Fund Limited Partnership is calling for Partnership Expenses and General Partner Share (GPS) for the period 1 January 2011 to 30 June 2011. A net Distribution is due to you.

1. We refer to the amended and restated limited partnership agreement dated 31 May 2010 constituting the Partnership (the Partnership Agreement) and to your Commitment to the Partnership of \$600,000.00. Capitalised terms defined in the Partnership Agreement shall have the same meaning in this letter except where the context otherwise requires.

2. This Distribution is in respect of New Capital Fund Limited Partnership's investment in XYZ Company. As a result \$0.00 of Distributions (3.2% of your

commitment) and \$4,430.09 of capital call for GPS and Partnership Expenses for the first half year of 2011 (0.7% of your commitment), a net Distribution of \$-4,430.09 is due to you.

3. This distribution is pursuant to Clause 4.1.1.2 of the Partnership Agreement, whereby this Distribution will be available for redrawing in the future, as set out in the schedule attached.

4. This Distribution relates to a Distribution of \$2,761,153 made by XYZ Company. A new shareholder invested in ABC Toys, providing the firm with more resources to accelerate its development. Part of the new proceeds raised were used to repay the shareholders loan in the company that Established Capital Fund acquired in July 2010, with New Capital financing. The valuation of ABC Toys in the current transaction is above the valuation at which Established Capital Fund held it on its book as at 30 June 2010.

5. This amount will be repaid by telegraphic transfer to the account set out below on December 22, 2010. Should these account details be out of date or incorrect please inform us by email.

Please forward relevant information where details are incomplete.

~~Mrs. Emily Taylor~~

~~Bank: Bank Arizona~~

~~2455678910~~ Number:

~~BANK~~ 5792468135792468

~~SWIFT~~

~~(\$4,430.09)~~

Bank charges will be borne by the remitter so that the total amount received will be gross of any charges levied.

Yours sincerely,

For and on behalf of New Capital Limited



Schedule to Net Distribution (Distribution Notice 4 & Drawdown Notice 9)

Jenny Taylor

All amounts in \$

~~500,000.00~~ Commitment:

Contribution (prior to this net Distribution)	166,068.14
Remaining Commitment (prior to this net Distribution)	433,931.86

XYZ Company Distribution	18,901.22
Call for GPS	(3,300.60)
Call for Partnership Expenses	(1,129.49)

Total for net Distribution	14,471.13
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Drawdown	4,430.09
Drawdown (as a % of Commitments):	0.74%

Distribution available for drawdown:	0.00
Distribution available for drawdown (as a % of Commitments):	0.00%

Remaining Commitment (after net Distribution)	429,501.77
Remaining Commitment (as a % of Commitment after net Distribution)	71.58%

Total Drawdown to date	212,925.97
Total Drawdown to date (as a % of Commitment)	35.49%

Total Distributions to date	61,328.96
Total Distributions to date (as a % of Commitment)	10.22%

Total Distributed (as a % of Total Drawdown)	28.80%
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Registered Office details

Appendix IV

IV

Key dates in fair-value reporting of alternative assets

1958

The Small Business Act 1958 allowed the Small Business Administration to license private investment companies to assist with the financing of small entrepreneurial US businesses. The act's rules generally required the reporting of assets at the lower of cost or market.

Late 1970s

The Employee Retirement Income Security Act eased investment restrictions allowing more capital to flow into alternative investments; its rules required fair-value reporting.

1973

The American Institute of Certified Public Accountants (AICPA) releases the first version of the *AICPA Audit and Accounting Guide for Investment Companies*, indicating that investment companies should report assets at fair value.

1989 to 1990s

A group of investors and managers develop valuation guidelines. The US National Venture Capital Association (NVCA) does not endorse them, but the guidelines become known as the de facto *NVCA Valuation Guidelines* used in the 1990s.

2001

The European Private Equity and Venture Capital Association (EVCA) releases valuation guidelines allowing two methodologies: a cost approach and a fair-value approach.

2002

In the US, a self-appointed group of private equity general partners, limited partners, and service providers form the Private Equity Industry Guidelines Group (PEIGG) in response to the suggestion that some private equity general partners did not take into account the post-tech-bubble decreases in value.

December 2003

After extensive input, PEIGG releases its *US Private Equity Valuation Guidelines*.

March/April 2004

NVCA and ILPA (Institutional Limited Partners Association) issue statements supporting the *PEIGG Guidelines*.

October 2004

ILPA endorses the *PEIGG Guidelines*.

2005 and April 2006

International Private Equity and Venture Capital Valuation Guidelines are released, adopting the fair-value concept, and are subsequently endorsed by more than 40 non-US associations.

September 2006

FASB releases Statement No. 157 (now known as ASC Topic 820), *Fair Value Measurements and Disclosures*.

March 2007

PEIGG releases its updated *US Private Equity Valuation Guidelines* to

incorporate the concepts of SFAS 157.

October 2008 and April 2009

IASB releases Expert Panel Paper; FASB issues ASC 820-10-35 and ASC 820-10-65 (formerly FASB Statements FSP FAS 157-3 and FSP FAS 157-4).

Mid-2009

IASB releases proposed fair-value accounting standard for IFRS reporters, modelled after FASB's Topic 820.

September 2009

The IPEV Board releases updated *International Valuation Guidelines*.

September 2009

FASB releases new Accounting Standards Update with expanded disclosure requirements and fair-value estimation guidance for investors (limited partners) that hold interests in alternative investment funds.

December 2009

AICPA published a set of technical-practice aids relating to FASB's *Accounting Standards Update 2009-12*, which allows an investor to use net asset value reported by a general partner to estimate the fair value of an alternative investment, provided certain criteria are met. Among such conditions is a need for the general partner to actually produce net asset value based on the fair value of its underlying investments, and that net asset value has to be the same measurement date as the limited partner's own financial statements (known as in-phase reporting).

May 2011

IASB and FASB issued new guidance on fair-value measurement and disclosure requirements for IFRS and US GAAP. *IFRS 13 Fair Value Measurement* would provide, for the first time, a precise definition of fair value and a single source of fair-value measurement and

disclosure requirements for use across IFRS.

About PEI

PEI is the leading financial information group dedicated to the alternative asset classes of private equity, real estate and infrastructure globally. It is an independent company with over 70 staff based in four regional offices – London, Hong Kong, New York and Singapore – and is wholly owned by its management and employees.

We started in London in November 2001 when a team of managers at financial media group Euromoney Institutional Investor PLC, with the backing of US-based investors, bought out a group of assets that centred on the website PrivateEquityInternational.com. At the time the new company was called InvestorAccess, and the aim was to grow a specialist media business that focused on alternative assets – and private equity in particular.

In December 2001 we launched our first magazine: Private Equity International. A year after, we had run our first conference in London and published our first book. A year later, we had opened our New York office and launched two more magazines: PE Manager and PERE. Next came the opening of our Singapore office in 2005 and the launch of our fourth magazine PE Asia in 2006. In 2007 we released our first online database and the year after we added specialist training to the portfolio as well as an awards business. In 2009 we launched our fifth magazine, Infrastructure Investor.

In May 2007 the same managers completed a secondary MBO that enabled us to own all of the business we had built and give our original co-investors a great exit too. Renamed PEI, the company remains one of the few independent financial media groups active worldwide.

Today we publish five magazines, host five news websites, manage a very extensive set of databases dedicated to alternative assets, run in excess of 25 annual conferences globally, publish a library of more than 30 books and directories and have a fast-growing training business.

We have grown into a well-known and highly regarded media business that delivers detailed coverage of the main alternative asset classes of private equity, real estate and infrastructure. We have worked hard to

build a reputation for top-quality journalism that is written by our own staff and is delivered via accomplished print and digital channels. The same principles of accuracy, genuine market knowledge and excellence of delivery also inform our data, events and specialist publication activities.

In April 2009, PEI won The Queen's Award for Enterprise 2009. The award was made in the international trade category as we have more than doubled overseas earnings in just three years and we now conduct business in over 80 countries. As well as looking at our commercial performance, the judging process also examines the company's corporate social responsibility, the company's environmental impact and our relations with customers, employees and suppliers.





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